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**GROUPS OF COMPANIES: THE LIABILITY OF THE PARENT
COMPANY FOR THE DEBTS OF ITS SUBSIDIARY**

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ABSTRACT

The thesis seeks to derive a more realistic solution to the issue of group liability. Limited liability, as a legal means of serving social and economic necessities, fits uneasily within the context of the typical group of companies. This is due to a discrepancy between commercial reality and the legal regulation of groups. In commercial reality, a parent company and its subsidiaries typically conduct their operations as integral parts of the same economic unit, and the parent company is managerially responsible for the crucial functions of the subsidiaries. For company law, however, parent and subsidiary companies are considered separate and independent legal entities, and, in principle, the parent company has only limited liability for the subsidiary's debts. There is no coherent principle or set of principles in accordance with which the exceptional circumstances where liability may be imposed on the parent company can be ascertained. A description is given of the existing tendencies in legal areas other than company law and in the company laws of major jurisdictions. The material is analyzed and a comparison is carried out pointing to the need for an alternative group liability rule. This rule may proceed upon the assumption that the subsidiary company is not managed as an independent company by its parent and that there is a possibility of conflict of interests between the two.

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INTRODUCTION

A: THE PROFILE OF THE THESIS

"The question of limited liability of the parent company for the debts of an insolvent subsidiary on certain well-defined conditions is one of the great unsolved problems of modern company law"¹. Although this statement was made by Professor Schmitthoff almost one decade ago, it might well refer to the present status of company law since the issue is still not adequately addressed.

The problem is due to a discrepancy between the economic and the legal realities. In economic reality, the traditional, single company does not any longer constitute an independent economic agent, an independent firm; it constitutes merely a part of a much greater unit, the group of companies, which is the real economic agent. The different companies of the group act as a unit, are controlled and managed by the headquarters which, in fact, are responsible for a number of decisions.

However, the economic responsibility of the headquarters does not result in their legal responsibility for the operation of the members of the group. Headquarters are not, in principle, legally responsible for the consequences of their decisions versus the companies of the group. English company law is still based on the concept of the traditional company as an independent firm. Notwithstanding that the phenomenon of the group of companies is a familiar characteristic of the United Kingdom commercial life² and it is not ignored, either in the case law³ or in the Companies Acts⁴, company law has not yet adapted itself in a coherent way to

1. CL. SCHMITTHOFF, *Banco Ambrosiano and Modern Company Law*, J.B.L. 1982, p. 361 at 363.

2. In the list of the 50 UK's most profitable companies in the 1991-1992 edition of *Times 1000*, p. 74, one can hardly find a company which does not belong to a large group of companies.

3. See below, ch. VI, C.

the problems posed by the operations of such groups. With respect to liability issues and despite some recent developments⁵, the following dictum of Templeman L.J. in Re Southard & Co.⁶ can still be considered as accurately reflecting the current legal position:

"English company law possesses some curious features, which may generate curious results. A parent company may spawn a number of subsidiary companies, all controlled directly or indirectly by the shareholders of the parent company. If one of the subsidiary companies, to change the metaphor, turns out to be the runt of the litter and declines into insolvency to the dismay of its creditors, the parent company and the other subsidiary companies may prosper to the joy of the shareholders without any liability for the debts of the insolvent subsidiary."

This thesis constitutes an attempt to establish the unsatisfactory state of the current law relating to the liability of the parent for the debts of its subsidiary as well as to find out whether there is a suitable alternative solution; especially, whether there should be some circumstances where the parent company should assume liability for the debts of its subsidiary.

i) The group: parent and subsidiary companies

The largest commercial and industrial enterprises of the world are typically organized as groups of companies⁷. They consist of hundreds of subsidiaries scattered throughout the world and they carry out the major part of the modern economic activity. It is estimated that multinational groups such as General Motors and Exxon produce more than the national economies of either Ireland, New Zealand or Pakistan⁸. Even for much smaller local operations, it is quite common to be split up between a number of holding and subsidiary companies⁹. The group of companies has thus replaced the independent single company as the typical form of organization; the latter is still employed only for the smallest private business.

Nevertheless, the precise legal status of the group of companies is still in a state of uncertainty. Although, in fact, the group constitutes a single economic unit seeking profit-maximization as

4. See below, ch. VII, A.

5. Such as IA s. 214 on wrongful trading; see below, ch. VII, B, iii.

6. [1979] 1 W.L.R. 1198, at 1208; see below, ch. VI, C, ii, a, 2.

7. It is significant that in the 1991-1992 edition of the Times 1000, p. 9, the world's top fifty industrial enterprises are listed as the world's top fifty industrial groupings.

8. P. BUCKLEY & M. CASSON, *The Future of the Multinational Enterprise*, 2nd ed., 1991, ch. 1 at 11-12.

9. T. HADDEN, *Control of Corporate Groups*, ed. Institute of Advanced Legal Studies, University of London, 1983, p.1.

a whole, in the eyes of law, the economic unity of the group is largely ignored. The companies constituting the group are considered as separate and independent legal entities with their own distinct interests.

The ultimate parent company is the principal shareholder in most of the other companies of the group, either directly or indirectly. Like every majority shareholder, the parent company has the legal power to control the subsidiary by participating in the decision making process at the subsidiary's general meeting and by appointing the majority of the members of the subsidiary's board. In principle, the directors of the subsidiary are not allowed to consider the interests of the parent company or of the whole group except in so far as they coincide with the interests of the subsidiary¹⁰.

In practice, however, the control of the parent is not confined to the control which is normally exercised by virtue of a majority shareholding. Overstepping its legal discretion, the parent company usually puts itself in charge of the actual management of the subsidiary¹¹. Major decisions concerning the subsidiary are taken on its behalf by the parent company. The resulting danger is that the parent company may give priority to its own interests even when they happen to conflict with the interests of the subsidiary.

For instance, it may be to the best interests of the parent company to structure the working capital of the subsidiary in a way which exposes third parties dealing with the subsidiary to increased risks. The subsidiary may be thinly capitalised by the parent or may be capitalised by a loan repayable on demand which may be secured on the assets of the subsidiary; this practice may put the parent ahead of ordinary trade creditors in the subsidiary's insolvent winding up¹².

Also, the parent company may exploit to its own benefit a corporate opportunity, e.g. an acquisition of a new business, which arose in the course of the subsidiary's operation. The parent company may also decide to close down one subsidiary if it considers that the closure of the subsidiary produces economies of scale for the entire group, notwithstanding that such a decision may significantly affect the reputation of the group.

10. See Charterbridge Corpn. Ltd. v. Lloyds Bank Ltd., [1970] Ch. 62 at 74; see also the Australian High Court's decision in Walker v. Wimborne, (1976) 50 A.L.J.R. 446.

11. See below, ch. III, B, ii, c.

12. A.J. BOYLE & R.C. SYKES (ed.), Gore - Browne on Companies, 44th ed., 1986, vol. I, supp. 13, p. 1007.

Hence, unlike the individual majority shareholder, the parent company may have a reason to manage the subsidiary contrary to its own interests and may even put its existence in jeopardy. This possibility creates the danger that the subsidiary may be made unable to honour its contractual or non-contractual commitments which it incurred during its course of operation. In these circumstances, the question arises whether the parent company, as the "head and the brain of the trading venture"¹³, should be held responsible for the subsidiary's commitments, and if yes, under what conditions.

ii) The corporate personality concept and the limited liability rule

As a general rule, a company is considered a legal person distinct from the persons who are its members. It is, accordingly, empowered to sue and to be sued on its own name, to own property and, more importantly, to assume its own obligations for which it, alone, is the only liable.

In principle, it makes no difference whether the members of the company are individuals or companies themselves. Thus, a company holding shares in another company is deemed to have a legal personality distinct from the company in which the shares are held. Therefore, in law, parent and subsidiary constitute separate and independent legal entities notwithstanding that, in fact, they may be operating as closely interrelated parts of the same economic unit.

As a consequence, parent and subsidiary have to meet exclusively their own set of obligations and the one company cannot be held liable for the obligations of the other. Like any other shareholder, the parent company is protected by the limited liability rule. According to this rule, the members of a company are not liable to the company or its creditors beyond the amount of their subscription; they cannot be obliged to contribute to the company more than the extent of any unpaid amount for which they subscribed. In the event of the winding up of the company on the grounds of insolvency, the company's creditors cannot direct their claims against the members' personal property, unless there is a guarantee to this effect. Thus, the parent's only liability towards the subsidiary is to pay the amount agreed on subscription for the shares in the subsidiary; a parent is not liable for the debts of a subsidiary which is wound up on the grounds of insolvency.

13. Said per Atkinson J., in Smith, Stone & Knight v. Birmingham Corporation, [1939] 4 All E.R. 116 at 121.

The rule of limited liability is deemed to be a logical consequence of the concept of corporate personality and, as a result, there is a close association between the two¹⁴. Therefore, the imposition of liability on the parent for the subsidiary's debts would entail "lifting the corporate veil", i.e. ignoring the different corporate personalities of parent and subsidiary considering that they constitute parts of the same economic entity¹⁵, to the effect of abrogating the limited liability rule.

iii) The thesis' argument

The thesis proceeds upon the argument that the legal rule of limited liability emerged in order to serve economic and social necessities and not as a natural attribute of corporate personality. With limited liability it was intended to encourage the creation of companies and the widest possible participation in them, thereby producing socially useful specialization and diversification of risks, and, eventually, economic growth.

Consistent with this argument is the expectation that the rule of limited liability should not apply where there are other economic and social necessities which deserve to be given priority. In particular, limited liability should not apply where its application would produce a social cost which is not offset by any countervailing social benefit. In this case, "lifting the veil" to the effect of imposing liability for the debts of a company on a person other than the company itself, could be seen as a mechanism for the preservation of balance between social benefit and social cost which would be disturbed in the case of adherence to the limited liability rule¹⁶.

In particular with respect to the parent-subsidary context, it appears that there are cases where the limited liability of the parent for the debts of its subsidiary does not serve social or economic necessities. In the majority of the groups, where subsidiary companies have no real autonomy but they virtually constitute a tool of operation or a department of the parent company¹⁷, the limited liability of the parent lacks reasonable justification. It serves not as a mechanism for diversification and specialization of risk but as a mechanism for the

14. "It follows from the fact that a corporation is a separate person that its members are not as such liable for its debts." L.C.B. GOWER, *Gower's Principles of Modern Company Law*, 5th ed., 1992, p. 88; "...separate legal personality is, in English law inconsistent with the members of an association being liable for its debts." J.H. Rayner (Mincing Lane) and others v. Department of Trade and Industry and others, (1987) BCLC 667 at 692 per Staughton J.; see also [1988] 3 WLR 1033 (CA) at 1087 per Kerr L.J.; see below, ch. VI, A.

15. L.C.B. GOWER, *Gower's Principles of Company Law*, 5th ed., 1992, p. 108.

16. See TH. LIAKOPOULOS, *I arsi tis aftotlias tou nomikou prosopou sti nomologia* ("Lifting the veil" in the Jurisprudence), Athens 1988, pp. 11-13.

17. See below, ch. III, B, ii, c.

segmentation of the risk which is borne out of the operation of the whole group as a unified economic unit. In this case, the socially worthwhile effects of limited liability are, to a large extent, absent, while third parties and the society at large have to cope with increased risks.

Accordingly, the rule of the limited liability of the parent for the subsidiary's debts should be replaced by a rule which is in conformity with the economic realities of the parent-subsidiary relationship. Primary concern of this rule should be to preserve the balance between social benefit and social cost, i.e. to satisfy the need for economic growth without overlooking the interests of third parties.

Liability should be imposed on the parent for the debts of its subsidiary especially where the parent manages the subsidiary otherwise than as an independent company, i.e. where the parent's management entails the submission of the subsidiary's interests to the interests of the parent. What elements should constitute "management of the subsidiary otherwise than as an independent company" is a question of fact and the answer should be derived from the experience of all those legislative and judicial attempts to link the management of the parent with its liability for the subsidiary's debts.

B: A SUMMARY OF CONTENTS

To question the applicability of limited liability in the parent-subsidiary context, it is necessary, as Farrar and Prentice point out, to ask what are the underlying economic purposes of limited liability and to what extent do they justify or require the doctrine to apply to groups of companies¹⁸. Accordingly, the first part of this thesis focuses on the origins, the rationale and the economic significance of limited liability with reference to the single, independent company as well as with reference to the group.

The first chapter traces the history of the emergence of limited liability in the U.K. with a glance at the developments made in the battle for general incorporation. For almost twenty years, between 1837 and 1855, the issue of limited liability was the central point of a legal and commercial debate. A closer consideration of this debate reveals how limited liability emerged and which were the main arguments advanced, both in favour and against its introduction. This historical overview shows that limited liability has not emerged as a necessary attribute of corporate personality but as a legal means of achieving a major economic and social purpose:

18. J.H. FARRAR, N. FUREY, B. HANNIGAN, *Farrar's Company Law*, 3rd ed., 1991, p. 545; D.D. PRENTICE, *Groups of Companies: the English Experience*, in K. HOPT (ed.), *Groups of Companies in European Laws*, 1982, vol. II, 99 at 128.

the purpose of encouraging more people to participate, as members of a company, in economic activity.

The second chapter concentrates on the economic significance of limited liability in the context of a single and independent company. The analysis is divided in two parts: in the first, the contribution of limited liability to risk-taking and to the minimization of the costs involved in carrying out an operation through a single company is examined; in the second, the focus shifts to the impact of limited liability on the distribution of losses arising out of a company's failure. In the latter part, the position of the creditors is examined since, by virtue of the interposition of limited liability, creditors are asked to bear the costs of the company's failure.

The third chapter is largely based on the results of a small survey which was undertaken for the purposes of this thesis. Group officials were interviewed on the structure and the affairs of their group. According to the results of the survey which, in fact, reconfirm the results of previous surveys, groups of companies operate in most cases as single economic units and a subsidiary company is nothing more than the legal framework for one small part of these single units. With regard to the most important aspects of a subsidiary's operation, the subsidiary's management cannot be compared to the management of an independent company. The general policy of the subsidiary as well as its financial and investment policy is, almost invariably, determined by the parent company with a view to the group's overall interests; the real decision-making centre is the board of the parent company where senior subsidiary officials are required to account and report regularly.

In the fourth chapter and in the light of the results of the survey, the economic significance of the limited liability rule is assessed in the context of the typical parent-subsidiary relationship. The extensive management of the subsidiary by the parent, which was observed in most of the groups contacted, greatly distinguishes a subsidiary company from a single, independent company. This particular feature renders the cost-minimization function of limited liability almost ineffective in the parent-subsidiary context; moreover, the same feature creates additional risks for the subsidiary's creditors and, at least for some of them, becomes a potential source of injustice. On aggregate, there is very weak, if any, justification for the protection of the parent company by limited liability.

The second part constitutes a search for an alternative liability rule which will best reflect the conclusions reached in the first part. The main element which renders unjustifiable the application of limited liability in the parent-subsidiary context is the management of the subsidiary by its parent. Therefore, any alternative rule proposed should constitute a reasonable

and effective way of linking the management of the subsidiary by its parent with the parent's liability for the subsidiary's debts.

The second part starts with the fifth chapter, where the response of various legal areas to the emergence of the group as the predominant form of business organization is examined. It is observed that there are some aspects of the operation of a group which have been dealt with by the relevant authorities on the basis that the group constitutes a single economic unit and the parent company is extensively involved in the management of its subsidiary. The extensive management by the parent triggers a number of legal consequences in the areas of private international law, competition law, labour law, accountancy and taxation.

The legal significance of the operation of the group as one unit in these areas can be contrasted with the current position in company law; there, with very few exceptions, the exercise of parental control over the subsidiary has not yet been decisively linked with the abrogation of the limited liability of the parent.

The sixth chapter starts the search for relevant company law solutions by focusing mainly on the English case law on groups of companies. Although the Salomon doctrine which dictates the strict adherence to the corporate personality principle has been held valid in some cases involving groups of companies, there are other cases where this doctrine has been disregarded. These cases rest mainly under the general category of "lifting the veil" jurisprudence and they recognized and gave some effect to the exercise of management by the parent company over its subsidiary. It is observed however, that, unlike the relevant American cases, in the English cases on groups it was rarely attempted to link the exercise of parental management with the parent's liability for the subsidiary's debts. Nevertheless, it is interesting to focus on these cases and especially on the facts upon which the decisive degree of parental management was established.

The seventh chapter deals with the English statutory provisions which have application in a parent-subsidary situation. First of all, there are the definitions of the parent-subsidary relationship as well as miscellaneous provisions concerning parent and subsidiary companies. To a great extent, these provisions make use of the criterion of control by the parent as a precondition for their application. Secondly and more importantly, there are provisions according to which liability may be imposed on the parent for the debts of its subsidiary on the basis of evidence indicating a certain degree of managerial involvement by the parent. It is important for our purposes to assess the degree of protection that these exceptions actually

provide to the creditors of subsidiaries and, also, to consider whether they can be regarded as remarkable steps in the search for an appropriate liability regime for groups of companies.

The eighth chapter deals with the German, French and the European Community legislative and judicial attempts to link parental management with parental liability. The solutions proposed by the German *Aktiengesetz*, the French company law, the former draft of the European Bankruptcy Convention, the former draft of the European Company Statute and the draft Ninth Directive on Groups of Companies as well as relevant decisions of the courts are considered. It is important to detect the nature and degree of parental management which triggers the liability of the parent company as well as the kind of evidential basis upon which the required nature and degree of management is established.

In the concluding chapter, an attempt is made to compare all the different solutions proposed or given and to combine them in order to formulate a rule which appropriately links the management by the parent with its liability for the subsidiary's debts. It is intended to strike a balance between strict regulation and case-by-case solution. Otherwise, it is likely that the implementation of any proposition will create more problems than those which it purports to solve.

PART I: LIMITED LIABILITY: AN UNSUITABLE RULE FOR GROUPS OF COMPANIES

CHAPTER I: THE ORIGINS OF LIMITED LIABILITY

The application of limited liability to modern companies is nowadays self-evident. The fact that a company is a separate legal person implies that it has its own rights and liabilities. Shareholders have no obligation to meet the company's liabilities and, in the absence of personal guarantees, they cannot be obliged to contribute any amount beyond the nominal value of their shares.

However, this is not always the case and as Farrar points out "[a]lthough there is a tendency to equate the two, legal personality and limited liability are two separate concepts. A company can be a separate legal person but its shareholders may still have unlimited liability for its debts"¹. Besides, under the English Limited Partnerships Act 1907, liability is limited, at least for some of the partners, although a partnership is not considered a legal person; on the contrary, the Scottish partnership as well as its equivalent in most Civil Law countries (e.g. the French *société de personnes*), have legal personality although the liability of all or some of their members is unlimited.

Especially in the United Kingdom, the modern type of the company registered by shares survived for a period without limited liability. Just after the introduction of general incorporation by virtue of the Joint Stock Companies Act of 1844 and for almost twelve years (1844-1855) companies were incorporated but without limited liability. However, before and during this period, the expediency of introducing limited liability constituted a debated issue. Between 1837 and 1855, when limited liability was eventually introduced, five parliamentary committees considered whether it would be beneficial to the community at large to limit the liability of members in one or another form.

1. J.H. FARRAR, N. FUREY, B. HANNIGAN, *Farrar's Company Law*, 3rd ed., 1991, p. 82.

The discussion over limited liability which took place during the proceedings of those Committees is of particular importance. It serves as evidence that the introduction of limited liability was totally disassociated from the promulgation of the corporate entity concept. The rule of limited liability did not emerge as a natural consequence of the concept of the company as a distinct legal person. It emanated from the socio-economic necessity to involve as many people as possible in economic activity.

A: THE PRE-1837 PERIOD

i) Chartered and statutory companies

Before the introduction of general incorporation in 1844, an association of persons could be incorporated either through the grant of a charter by the Crown or through a special Act of Parliament. A Charter or an Act of Parliament was necessary to transform a joint stock association into an incorporated company. Chartered and statutory companies enjoyed the privileges of their corporate status. Whereas there seems to be no doubt that members of statutory companies were protected by limited liability², such protection was not always conferred on members of chartered companies.

It is reported that among the first chartered companies to adopt a limited liability clause was the British Fishery Society which, because of a loss in 1633 and 1634, resolved that further capital subscribed should be held exempt from any liability for the existing deficit³. Some years later, by an Act of 1662⁴, the shareholders of that company together with the shareholders of the East India Company and the Royal African Company were relieved of liability for the company's losses beyond the full nominal value of their shares because those companies were at that time considered of vital importance⁵.

2. H. RAJAK, *A Sourcebook of Company Law*, 1989, p. 27; see, also, the Act of Parliament incorporating the Eastern Counties Railway Company (in H. RAJAK, *ibid.*, pp. 30-35), art. CLIX, where it was provided that "no proprietor of any share in the capital stock of the said company shall, under the authority of this Act, be called upon or be liable to pay any greater sum of money than, with the principal money already paid on account of the subscription for such shares, will amount to the sum of twenty-five pounds in respect of each such share, over and besides any interest paid or payable by reason of default in payment of calls as aforesaid".

3. W.E. MINCHINTON, *Chartered Companies and Limited Liability*, in T. ORHNIAL (ed.), *Limited Liability and the Corporation*, 1982, p. 137 at 141.

4. 12 Charles II c 24.

5. W.E. MINCHINTON, *op. cit.*

In 1671, in the case of Salmon v. The Hamborough Co.⁶, it was confirmed that the liability of the members of a chartered company was unlimited unless its charter specified that it was limited. Moreover, many charters, expressly or impliedly, conferred a power on the company to make calls on its members for further contributions⁷; if a company with this power was not taking the necessary action against its members, the court could compel the company to make the calls for the benefit of its creditors⁸.

ii) The Bubble Act

In 1720, the famous Bubble Act⁹ was passed in order to cope with a speculative boom in the shares of chartered companies. That Act remained in force for more than one century although it is now considered an improper piece of legislation¹⁰.

The purpose of the Bubble Act was to prevent the frequent practice of commercial undertakings acting as corporate bodies without legal authority by buying up the shares of declining companies just in order to obtain their charters¹¹. Such undertakings "tending to common Grievance, Prejudice and Inconvenience of his Majesty's subjects" were declared to be illegal¹². On the contrary, normal partnerships were allowed to carry on business "in such manner as hath been hitherto usually and may be lawfully done according to the Laws of this Realm now in force"¹³.

The net effect of the Bubble Act was a preference for the unincorporated form¹⁴. Incorporating charters and Acts of Parliament were more reluctantly granted. In the absence of any other safe and readily available form, associations with joint stock capital adopted the unincorporated form and came under the law of partnership.

6. (1671) 1 Ch.Cas. 204, H.L.

7. L.C.B. GOWER, *Gower's Principles of Modern Company Law*, 5th ed., 1992, p. 23.

8. Salmon v. The Hamborough Company, op. cit.; for a criticism of this particular interpretation of the case, see D. JENKINS, *Skinning the Pantomime Horse: Two Early Cases on Limited Liability*, [1975] C. L. J., p. 308.

9. 6 George I c 18; Its full title was: 'An act to restrain the extravagant and unwarrantable practices of raising money by voluntary subscriptions for carrying on projects dangerous to the trade and subjects of this kingdom'.

10. Farrar characterises it "a poor commencement of English company legislation", while Gower points out that what that Act did is "somewhat obscure". See J.H. FARRAR, op. cit. p. 17 and L.C.B. GOWER, op. cit. p. 26, respectively.

11. See L.C.B. GOWER, op. cit., pp. 24-28; W.E. MINCHINTON, op. cit., pp. 142-143.

12. Section 18.

13. Section 25.

14. As Gower (op. cit., p. 29) characteristically says, "...the Bubble Act in the end caused a rebirth of the very type of association which it had sought to destroy".

iii) The pursuit of limitation of liability

Hence, until the first half of the nineteenth century, there were two alternative legal forms through which operations with joint stock capital could be carried out:

1. The unincorporated joint stock association regulated by partnership law with its agency, contract and trust components; and
2. The chartered or statutory joint stock company regulated by the provisions of the charter or of the Act of Parliament.

The privilege of limited liability was conferred only on members of companies of the second type, although not consistently. On the other hand, unincorporated associations, while free from expenses and delays, could not sue or be sued in their names and, more importantly, their members could not limit their liability. Since those associations were regulated by partnership law, they had to abide by the principal doctrines of partnership law, namely the lack of corporate personality for the association and the lack of limited liability for the partners¹⁵.

However, the principal doctrines of partnership law had been established and developed in order to meet the needs of associations of "few persons intimately known to one another and usually working together"¹⁶. But this was not the case with most of the unincorporated associations of the early nineteenth century. As Shannon points out, "[t]he exploitation of the new economic changes ... often required a larger capital than a few individuals could raise or would risk. A different kind of association grew up, a business union with numerous members, not well known to one another ... This was the unincorporated company. But the law of partnership was being applied to it without modification"¹⁷. To the members of such unincorporated companies, the principles of partnership law and especially unlimited liability were at best a nuisance and, at worst, personally disastrous since their entire property was subject to the risk of loss¹⁸.

Nevertheless, by virtue of the ingenious drafting of their documents, unincorporated associations managed to obtain nearly all the advantages of incorporation. The resulting "deed of settlement" companies achieved almost all the advantages of incorporated companies by the use

15. R.R. FORMOY, *The Historical Foundations of Company Law*, 1923, p. 26.

16. H.A. SHANNON, *The Coming of General Limited Liability*, *Economic History*, Jan. 1931, p. 267 at 271.

17. H.A. SHANNON, *ibid.*

18. See R.R. FORMOY, *op. cit.*, pp. 32-36, quoted in H. RAJAK, *op. cit.*, pp. 41-43.

of trust principles¹⁹. Particularly in order to achieve limited liability without the troublesome procedure of incorporation through a charter or an Act of Parliament, the draftsmen of that time resorted to two devices:

1. The *de facto* limitation of liability, as the consequence of the practical difficulties of suing all the individual members of an association²⁰; and
2. The contractual limitation of liability, by the use of clauses to this effect included in contracts entered into between the association and third parties²¹.

However, in the absence of a clear authority on the issue of limited liability, *de facto* and contractual limitation could not be considered as the optimal solution. *De facto* limitation simply counted on the difficulty of suing the whole fluctuating body of shareholders while contractual limitation required additional costs and protected members only in relation to the contract entered into between the company and the third party.

iv) The repeal of the Bubble Act

This was briefly the state of law and practice by the first quarter of the 19th century. The main feature was the lack of a satisfactory legal regime which could provide the business community with an attractive form of organizing an undertaking and would safely confer on investors the privilege of limited liability. Moreover, the widespread use of clauses limiting liability created a great inconsistency between the law and the contemporary practice²².

The reaction of the legislative authorities started in 1825, when the Bubble Act was repealed. S. 2 of the Bubble Act Repeal Act²³ empowered the Crown to grant charters of incorporation containing a regulation of a member's liability. In fact, the Crown was given the discretion not

19. L. C. B. GOWER, *op. cit.*, pp. 30-32; A. B. DUBOIS, *The English Business Company after the Bubble Act*, 1938, pp. 217-227, quoted in H. RAJAK, *op. cit.*, pp. 36-40.

20. See FORMOY, *op. cit.*, p. 41; H. A. SHANNON, *op. cit.*, p. 272.

21. Contractual terms of this kind were considered to be effective. See *Hallett v. Dowdall* (Queen's Bench Division 1852) 21 LJ QB 98. On the contrary, clauses limiting liability in the deed of settlement had binding force only between the members *inter se*. They had no effect on creditors, even if the latter had notice of them. See *Re Sea Fire and Life Insurance Company, Greenwood's Case*, (Court of Appeal, 1854) (1854) 3 De GM&G 459; 43 ER 180. The relevant extracts of both cases are quoted in H. RAJAK, *op. cit.*, pp. 50-60.

22. "The people by quietly adapting their practices to the law, in general manage to wrest or work the law to their practices, and changes in the law, when made, are frequently more nominal than real. At present the law ... is that every ostensible partner who shares the profits of a trading concern renders himself liable in the whole of his property to the whole of its debts; but in practice ... all the partners contract with each other, and the company contracts with every person it deals with, that all claims shall be confined to the subscribed fund of the company. Every person with whom it deals entering voluntarily into the contract, the principle of limited liability is, by common consent, fully carried out, whatever the law may say to the contrary." *Economist*, 1 July 1854.

23. 6 Geo. IV. c. 91.

only to establish any limit for the members' personal liability, but to even provide for unlimited liability²⁴. Although one would expect that this provision would encourage a greater readiness in granting charters, the authorities remained as strict as ever²⁵; in addition, the cost of obtaining statutory incorporation remained rather prohibitive²⁶.

Subsequently, the Trading Companies Act was enacted in 1834²⁷. This Act broadened the authority of the Crown by empowering it to grant by letters patent all the privileges of incorporation but without actually granting a charter. Its preamble stated that companies were being formed which it would be inexpedient to incorporate either in the full common law sense or in the truncated sense of the 1825 Act, and yet which it would be expedient to endow with some of the privileges of incorporation²⁸. The main privilege intended to be endowed was the ability to sue and being sued through officers representing the company; limited liability was still ignored. On the contrary, it was provided that judgements against the company should, with leave of the court, be enforceable against every member until three years after he had ceased to be a member²⁹. Therefore, limited liability could still only be conferred through the troublesome and costly procedure of petitioning for a charter or for an individual incorporating statute.

24. "... the Members of such Corporation shall be individually liable, in their Persons and Property ... to such Extent, and subject to such Regulations and Restrictions as his Majesty ... may deem fit and proper, and as shall be declared and limited in and by such Charter." (1825), 6 Geo. IV Cap XCI, Sect II. For comments on this section, see D. L. PERROT, *Changes in Attitude to Limited Liability - the European Experience*, in T. ORHNIAL (ed.), op. cit., p. 81 at 99; H. A. SHANNON, op. cit., p. 276.

25. See Report of 1850 on Investments for the Savings of the Middle and Working Classes, 1850, Vol. XIX, p.169, where it was stated that the expenses and the trouble to obtain a charter were preventing enterprises from undertaking useful operations.

26. See B.C. HUNT, *The Development of Business Corporation in England 1800-1867*, 1936, reissued 1969, p. 82, fn. 103, where two manifest examples of expensive statutory incorporation are quoted.

27. 4 & 5 Will. IV. c. 94.

28. Ibid.; see also H.A. SHANNON, op. cit., pp. 276-277.

29. Op. cit., s. IV.

B: THE FIVE REPORTS

i) The report of 1837

a. The report

By 1837, the 1834 Act was found ineffectual³⁰ and the Board of Trade asked from H. Bellenden Ker, a Chancery barrister, to prepare a report on the law of partnership³¹. This report was, in fact, the first attempt to bring the law in some conformity with the commercial reality and the first hesitant step towards the statutory introduction of limited liability.

H.B. Ker recognized the unsuitability of partnership law for associations of a joint stock character and did not hesitate to report that the application of partnership law to such associations "amounts to an absolute denial of justice"³². He considered that the principal difficulty of the existing law was arising "in legal proceedings taken by or against partners, or in suits *inter se*, where the partners are numerous"³³. He proposed that the company should sue and be sued in the names of the officers³⁴.

He also considered whether it would be expedient to introduce a law authorizing persons to become partners with limited liability³⁵. However, he did not consider the statutory introduction of a form of organization such as, or similar to the modern limited liability company. He merely considered the introduction of the partnership *en commandite* model, which had already been introduced in France.

According to that model, partners who remained unknown to the public and who did not participate in the management of the association were liable only to the extent of the capital for which they had subscribed. The obligations of the association beyond its capital would be met entirely by the personal property of the managing partners³⁶.

30. H.A. SHANNON, *op. cit.*, p. 277.

31. 1837 B.P.P., Vol. XLIV, 399.

32. *Ibid.*, pp. 402, 404.

33. *Ibid.*, p. 401.

34. *Ibid.*, p. 406.

35. *Ibid.*, p. 400.

36. For a thorough description of the model, see *ibid.*, pp. 417-419.

The majority of the opinions did not support the introduction of the French model into English law³⁷. H.B. Ker considered, therefore, that "it would not be expedient to recommend the introduction of the measure"³⁸.

b. The discussion

As the application of limited liability was discussed mainly in the context of the introduction of the model of the partnership *en commandite*, the general introduction of the model of a limited liability incorporated company was not seriously considered.

Those who recommended the introduction of partnerships with limited liability stressed that limited liability would enable undertakings with good prospects to attract wealthy investors who were not willing to participate in the management of the concern and to subject themselves to the rigours of unlimited liability. Protected by limited liability, non-managing investors could advance a certain amount of capital to the concern without risking their entire personal property in the event of a failure. A distinction was thus drawn between partners who manage the company and partners who simply advance to it a specified amount of capital, i.e. passive partners.

On the other side, for those who opposed to the measure, limited liability was not necessary because there was no indication of economic pressures for additional investment.

In general, limited liability was considered merely as a legal device to achieve economic goals; it was approached as a privilege and as an incentive to invest and not as an indispensable attribute of joint stock associations, either partnerships or companies. Its application was discussed more as a matter of economic policy than as a matter of legal consistency.

The majority view on the issue was fairly represented in the words of Thomas Tooke who gave the most thoughtful opinion:

"The general, if not universal rule of commercial transaction is, that the individual is liable to the full extent of his means, for the engagements entered into by himself, or on his behalf, or jointly with others; and it is only by the interposition of a special law that can be shielded from the more general one of being answerable, in all cases by the whole of his property, and, in some

37. *Ibid.*, p. 420.

38. *Ibid.*, p. 421.

cases, by his person, for such engagements. This interposition, then, most assuredly must be considered as conferring privilege."³⁹

He reluctantly admitted that the law of unlimited liability operates as a disincentive for investment:

"[I]t is a great hardship in cases where the friends or relations of an individual (a deserving young man, for instance) might be willing to embark a certain sum in trade, under his management, and to risk the whole amount so embarked in the result of the business, but not more, should be precluded from so doing by the law as it stands, which makes their whole property liable if the concern should fail"⁴⁰.

However, he considered that limitation of liability would be beneficial to the business community only in exceptional cases:

"I am inclined, therefore, to think that the privilege should be confined, as heretofore, to special cases in which it might be satisfactorily shown that an undertaking, desirable in public point of view, could not be carried into effect without limiting the responsibility of subscribers. Canals, docks, bridges, railways, and other undertakings partaking of the nature of public works, are understood to come within this description."⁴¹

The same view was held by G.G. de H. Larpent:

"[E]xcept in cases in which united capitals are necessary for the accomplishment of the particular object, the capital required being larger, the risk run being greater, than can be borne by any individual capitalist, or any number of capitalists, ... it appears to me that joint stock companies, of which the subscribers are relieved from any responsibility beyond the amount of their shares, are not deserving of the support of the law."⁴²

C.T. Swanston argued that the general introduction of partnerships with limited liability (*en commandite*) would be advantageous, insofar as it would lead to the application of capital in

39. Communication from Thomas Tooke, *ibid.*, p. 432.

40. *Ibid.*, p. 431.

41. *Ibid.*, p. 432.

42. *Ibid.*, p. 438.

commercial adventures, which was withheld from them by reason of the unlimited liability⁴³. He also argued that any objection to the model would be removed by the introduction of means enabling the creditor to ascertain the extent of every partner's liability⁴⁴.

Likewise, J.H. Palmer stressed that limited liability should be coupled with some form of publicity. Talking about the limited liability of the chartered and statutory joint stock companies, he argued that without the publicity of their accounts at stated periods, their limited liability "would be a public evil"⁴⁵.

The arguments against limited liability pointed to the absence of any indication that additional inducement for investment was necessary. Since there was no evidence of want of capital in the UK and capital seemed to be abundant, there was no reason for introducing limited liability.

For J.H. Palmer, there were no commercial partnerships, "which are of a legitimate character, and which offer a reasonable prospect of profit, which cannot at all times command adequate capital to carry them on"⁴⁶. For T. Tooke, there was no need for additional encouragement to bring capital into trade; "therefore, the proposed alteration of the law would be at least a work of supererogation"⁴⁷. Similarly, K. Finlay considered that any measure which intended to attract capital in an unnatural way to speculative objects would be very disadvantageous⁴⁸.

The only immediate effect of the report of 1837 was the enactment of the Chartered Companies Act of the same year, which, in fact, re-enacted the 1834 Act. Like the 1834 Act, the Chartered Companies Act⁴⁹ provided for the discretion of the Crown to confer on unincorporated associations some corporate privileges, and, especially, the right to sue and to be sued in the names of their officers. The liability of the members was to be regulated and it could be limited by letters patent to a specified amount per share.

Although this was the first statutory mention of limitation of liability by shares, not many companies made use of the provisions of the new Act. It is reported that in the following 17

43. *Ibid.*, p. 452.

44. *Ibid.*, p. 452.

45. *Ibid.*, p. 441.

46. *Ibid.*, p. 441.

47. *Ibid.*, p. 431.

48. *Ibid.*, p. 448.

49. 1 Vict. c. 73. For a brief comment on the Act, see H.A. SHANNON, *op. cit.*, 277.

years the companies which came under the Act were not more than 50⁵⁰. Associations without limited liability were still the norm. Their members kept on relying on the inadequate and uncertain protection provided by the practical difficulties of suing and levying execution on their personal property as well as on the contractual limitations of liability.

ii) The report of 1844

a. The report and the 1844 Act

After 1837, joint stock associations were operating under three forms:

1. As unincorporated associations with unlimited liability for their members; or
2. As unincorporated associations with letters patent conferring on their members the main privileges of incorporation and, sometimes, limited liability; or
3. As companies incorporated under a charter or a statute, often with limited liability for their members.

During this period, many undertakings were found to operate fraudulently⁵¹. A manifest example was the fraudulent operation of the West Middlesex Insurance Company which acquired good reputation and credit by the public by keeping an account with the bank of England of 10,000 l; but when they got 300,000 l, they "walked off with it"⁵². In another case, a shareholder and director of a company was able to attract funds to his fraudulent scheme by concealing from prospective investors the extent of the wealth of the persons who were already shareholders in the concern; moreover, by the means of fictitious transfers of shares, he was always elected as director of the company⁵³.

To cope with this sort of fraudulent devices, a Parliamentary Committee was appointed in 1841⁵⁴. This Committee revived in 1843 and gave its famous report in 1844⁵⁵ under the chairmanship of Gladstone, then President of the Board of Trade. The purpose of the 1844

50. L.C.B. GOWER, *op. cit.*, p. 38.

51. L.G.B. GOWER, *op. cit.*, p. 38.

52. 1844 B.P.P., Vol. VII, Evidence of Peter Laurie, p. 63; see also Evidence of E. Taylor, pp. 108-113.

53. Evidence of T.H. Bothamley, *ibid.*, p. 123; for other examples of fraudulent operations, see *ibid.*, p. 74 and pp. 89-93.

54. Hansard, 1841, LVII, 842.

55. 1844 B.P.P., Vol. VII, p. 3.

Committee was "to inquire into the State of the Laws respecting Joint Stock Companies (except banking companies), with a view to the greater Security of the Public"⁵⁶.

In its report the Committee identified three classes of "bubble" companies: those which were founded on unsound calculations, those which were badly managed and those which were established "for no other purpose than to create shares for the purpose of jobbing in them, or to create under pretence of carrying on a legitimate business the opportunity and means of raising funds to be shared by the adventurers who start the company"⁵⁷.

The Committee considered that with respect to the latter class of companies, the security of the public would be better served by the full publicity of the association through the registration of its principal particulars. According to the Committee's proposals, upon provisional registration the company could operate for certain strictly limited preliminary purposes, and upon complete registration the company would become incorporated and fully operative⁵⁸. Any future company not registered would not be lawful⁵⁹.

On the issue of the introduction of partnerships with limited liability, the Committee did not express an opinion, because, "though highly worthy of consideration, those subjects do not appear to fall within the scope of the reference which has been made to them"⁶⁰.

The proposals of the Committee were approved and were enacted in the Joint Stock Companies Act of 1844⁶¹. A joint stock company was there defined as a commercial partnership with more than 25 members or with a capital divided into freely transferable shares. Such a company was incorporated in order to carry on its business upon complete registration⁶². According to s. 25 of the Act, members were personally liable for the debts of the company. Their liability was to cease three years after they had transferred their shares by registered transfer and creditors had to proceed first against the assets of the company⁶³.

56. *Ibid.*

57. *Ibid.*, p. 4.

58. Resolutions of the Committee, ss. 1, 2, 3 and 4, *ibid.*, pp. 12-13.

59. S. 6, *ibid.*, p. 13.

60. *Ibid.*, p. 6.

61. 7 & 8 Vict. c. 110.

62. For the main alterations introduced by the 1844 Act, see H.A. SHANNON, *op. cit.*, pp. 279-282.

63. S. 66.

The absence of limited liability was the main feature of the 1844 Act. It is, in fact, paradoxical, that whereas by the Acts of 1834 and 1837 limited liability could be granted to unincorporated associations by virtue of letters patent, the 1844 Act denied limited liability to incorporated companies. This fact demonstrates once again the total disassociation between corporate personality and limited liability.

b. The discussion

Notwithstanding that the consideration of the issue of limited liability fell beyond the scope of the Committee's task, the issue was not totally ignored. In fact, the expediency of limiting the member's liability was discussed at considerable length by some participants and some very significant points were raised.

T.H. Bothamley argued that the liability of the shareholders ought to be limited to the amount of the subscribed capital, because such alteration would "induce persons of respectability to enter into companies and to vest their capital in the undertaking"⁶⁴. He explained his view as follows:

"[I]f you ask me to take 20 shares in a company amounting to 500 l, I do not very much care whether I lose it or not, but if after my experience of a company like that you asked me to become a member of a company in which my whole property is risked, I would have nothing to do with it."⁶⁵

J. Duncan openly suggested that the law should allow, in addition to partnerships with limited liability, the operation of joint stock companies with limited liability on the condition that the kind of liability is made known to the public⁶⁶. He pointed out the following:

"If a joint stock company could be easily established without involving the subscribers for more than their subscriptions, the necessary capital might be easily found, as the risk of loss would be divided among a great number of persons; thus the enterprising promoters of a scheme, who resolve to get the capital they want, would be furnished with it, and the result might be possibly some great advantage to the community."⁶⁷

64. *Ibid.*, p. 126.

65. *Ibid.*

66. *Ibid.*, p. 209.

67. *Ibid.*, p. 172.

He referred to the prevalence, in practice, of the limited liability clauses which were inserted either in deeds of settlement or in contracts with third parties. He argued that the practice of inserting clauses limiting liability into contracts with third parties had become so common as to "have had the effect of setting aside the ordinary principle of law"⁶⁸. He also recalled that he "inserted a clause in the deed of settlement of ..., actually prohibiting the directors from entering into contracts with third persons unless such a stipulation were inserted in the contracts"⁶⁹.

J. Parkes was also in favour of the introduction of limited liability. He considered that "the two modifications of partnership in French law, the *commandite* and the *anonyme*, might, more or less, to certain classes of companies, be well applied in England"⁷⁰.

On the contrary, H.B. Ker who had prepared the report of 1837, considered that there is a certain security to the public in the element of unlimited liability⁷¹. On the introduction of partnerships with limited liability, he said:

"Assuming that you have some rich persons or persons of high character and credit who are liable *in solido*, backed by a large body of limited shareholders adding capital, a partnership of that kind, one should say, would be the most safe that could be devised; but it may be doubtful whether a law permitting that would not be open to evasion and some fraud."⁷²

However, in spite of the fact that several participants discussed the issue of limited liability, the Committee avoided to express its opinion on the matter and the legislature introduced the model of registered incorporated companies with unlimited liability.

68. *Ibid.*, p. 168.

69. *Ibid.*, pp. 167-168.

70. *Ibid.*, p. 234.

71. *Ibid.*, p. 189.

72. *Ibid.*

iii) The report of 1850

a. The report

The 1844 Act did not put an end to the debate over limited liability. The depression of 1845-1848⁷³ as well as the acceptance of limited liability for railways⁷⁴ kept the issue under discussion. Besides, the view that large undertakings of a public character should become more attractive to middle and working classes strengthened the public pressure towards the introduction of limited liability. Limited liability was considered to be the appropriate means to enable these classes to participate in economic activity and to improve their condition. As Hunt points out, "[t]he argument for limitation of liability thus had acquired a clear tinge of social amelioration"⁷⁵.

"To consider and suggest Means of removing Obstacles and giving Facilities to safe Investments for the Savings of the Middle and Working Classes"⁷⁶ a Select Committee on Investments for the Savings of the Middle and Working Classes was appointed in 1850. As it was reported "[t]he great change in the social position of multitudes, from the growth of large towns and crowded districts, renders it more necessary that corresponding changes in the law should take place, both to improve their condition and contentment, and to give additional facilities to investments of the capital which their industry and enterprise is constantly creating and augmenting"⁷⁷.

However, far from proposing any alteration to the existing liability regime, the Committee confined itself to the assertion that the power to grant charters conferring limited liability "has seldom been exercised, does not seem guided by any clear rule, and involves expense greater even than that of obtaining an Act of Parliament"⁷⁸. Accordingly, it was suggested that

73. L.G.B. GOWER, *op. cit.*, p. 41.

74. "It was the railways that won the acceptance of general limited liability." H.A. SHANNON, *op. cit.*, pp. 286-287. See also J. HICKS, *Limited Liability: The Pros and the Cons*, in T. ORHNIAL (ed), *op. cit.*, pp. 11-12; B.C. HUNT, *op. cit.*, p. 104.

75. B.C. HUNT, *op. cit.*, p. 120. He also quoted (p. 121) the following extract from an article in *Edinburgh Review* (XCV, 1852, 408):

"To have saved money and invest it securely, is to become a capitalist; is to have stepped out of the category of the *proletaires*; and to have deserted the wide and desolate multitude of those who *have not* for the more safe and reputable companionship of those who have."

76. 1850 B.P.P., Vol. XIX, p. 171.

77. *Ibid.*, p. 172.

78. *Ibid.*, p. 171.

charters "should be granted with the greatest caution, but at a far more reasonable cost"⁷⁹.

b. The discussion

The Committee of 1850 approached the introduction of limited liability clearly as an issue with sociopolitical dimensions. Nevertheless, the discussion taken place was not confined to the possible effects of limited liability on the middle and working classes, but some views of a more general character were put forward.

J.M. Ludlow was among the main supporters of limited liability. He disapproved the model of partnership *en commandite*, not because of the limited liability of the sleeping partners but because of the unlimited liability of the managing partners. Accordingly, he suggested that a number of partnerships should operate with limited liability for all members, providing that complete notice is given to the public⁸⁰. Pointing to the experience of railways, he stressed that "as soon as a single opening is given for limited liability, the whole enterprise of the country rushes into it"⁸¹.

He considered that the law of unlimited liability prevents a person of prudence, caution and capital as well as the humbler classes of society from taking part in local enterprises. It seemed to him that only three classes of persons would engage as shareholders in a large joint stock company with unlimited liability: "fools who think they can lose nothing, rogues who know they have nothing to lose, and may gain all, and gamblers, who will stake everything upon the cast of a die"⁸².

John Stuart Mill, the famous economist who was also in favour of limited liability, argued that unlimited liability tends to induce prudent people, when they are no longer able to give personal attention to business, to take their capital out of enterprises and to abstain from investing it in them⁸³. He considered that "the great value of limitation of responsibility as related to the

79. *Ibid*; see also above, A, iv.

80. *Ibid.*, pp. 178, 187-188.

81. *Ibid.*, p. 180.

82. *Ibid.*

83. *Ibid.*, p. 263.

working classes would not be so much to facilitate the investment of their savings, not so much to enable the poor to lend to the rich, as to enable the rich to lend to the poor"⁸⁴.

J. Stewart held that the alteration of the law of unlimited liability would be beneficial; he stated that he had experienced occasions where "a person of respectability and character has been deterred from entering into an undertaking by the idea that he would be liable to the whole extent of his property if he took a single share in that concern"⁸⁵.

D. Le Marchant, on the contrary, opposed to the indiscriminate introduction of limited liability, as it would cause prudent men to embark, and money to be wasted in very imprudent undertakings. Moreover, "if the managers of this undertaking chose to incur very serious liabilities beyond the capital of the company, then the persons dealing with them would suffer"⁸⁶.

H.B. Ker who was, once again, asked to give his opinion, alleged that in a country where there is plenty of capital for the ordinary purposes of trade, it would not be expedient to allow trading under limited liability. However, "where a business or an undertaking of any kind is such that it either requires a very large capital, or the undertaking is hazardous, and therefore persons are unwilling to invest their capital in the undertaking, or where the business is such that it is managed by directors, there if the object be reasonable and fair ... limited liability should be allowed"⁸⁷.

Although the Committee of 1850 discussed the introduction of limited liability at considerable length, it merely recommended an improvement of partnership law and a relaxation in the charter system. Despite the fact that joint stock companies incorporated through registration had been in existence since 1844, the extension of limited liability to them was not discussed. Unlimited liability was still regarded as founded on "natural justice"⁸⁸ and it was suggested that

84. *Ibid.*, p. 254. This view was not adopted by some contemporary commentators. McCulloch, for instance, pointed out that the condition of the working classes would never be improved by encouraging them to invest because that would withdraw "their attention from the businesses to which they have been bred". *Partnerships, Limited and Unlimited Liability*, *Encyclopedia Britannica*, 8th ed., 1859, p. 322, quoted in B.C. HUNT, *op. cit.*, p. 122. A similar fear was expressed by an article in an *Economist*, according to which the introduction of limited liability would lead to "the hard savings of workmen being lost by intrusting them to imprudent or dishonest employers, or by facilities being afforded to rash and overconfident speculators". *Economist*, Vol. VIII, (1850), p. 537.

85. *Ibid.*, p. 207; see also p. 216 for the personal experience of S. Bowley who blamed the law of unlimited liability for not raising sufficient capital to carry out a plan advantageous for the working classes.

86. *Ibid.*, p. 201.

87. *Ibid.*, p. 237.

88. B. HUNT, *op. cit.*, pp. 123-124.

limited liability should exceptionally apply to certain undertakings not because they were incorporated but because of social and commercial necessities. Thus, emphasis was placed more on the socio-economic implications of limited liability than on any sort of legal reasoning.

iv) The report of 1851

a. The report

The report of 1850 had no immediate effect. The following year, another Committee undertook to "consider the Law of Partnership and the Expediency of facilitating the Limitation of Liability with a view to encourage useful Enterprise and the additional employment of Labour"⁸⁹.

The Committee of 1851 drew attention to the fact that the amount of personal property had been greatly increased and had been divided among large classes of the community "in the middle (or even the humbler) ranks of life"⁹⁰. However, because of the rule of unlimited liability, these classes were prevented from disposing of their property in a beneficial way for themselves and for the community at large. Unlimited liability was considered as one of the obstacles preventing "even the more thriving of the working classes from taking shares ... under the sanction of and conjointly with their richer neighbours; as thereby their self-respect is upheld, their industry and intelligence encouraged, and an additional motive is given to them to preserve order and respect the laws of property"⁹¹.

It was admitted that unlimited liability was applied successfully to "principal commercial transactions of this country, carried on by the most part by firms of few partners"⁹². However, "it would be of great advantage to the community to allow limited liability to be extended with greater facility to the shareholders in many useful enterprises, often promising at the same time public benefit and private profit, which are constantly called for by the increasing population and wants of our towns and populous districts"⁹³.

89. 1851 B.P.P., Vol. XVIII, p. 3.

90. *Ibid.*, p. 5.

91. *Ibid.*, p. 7.

92. *Ibid.*, p. 6.

93. "Such as water works, gas works, roads, bridges, markets, piers, baths, wash-houses, workmen's lodging houses, reading rooms, clubs, and various other investments of a like nature, chiefly confined to spots in the immediate vicinity of the subscribers." *Ibid.*

Nevertheless, the Committee merely recommended a greater readiness by the authorities in granting charters⁹⁴ and a review of partnership law since it was found that the best authorities were divided on the issue of the introduction of partnerships with limited liability⁹⁵. It also suggested the introduction of an easier mode of borrowing capital without subjecting the lender to a risk beyond the amount of the sum advanced⁹⁶. But it was pointed out that "due regard has to be paid to the importance of preventing the acquirement of undue or undeserved credit, or giving encouragement to ignorant or reckless speculation"⁹⁷.

b. The discussion

Like in the previous Committees, in the Committee of 1851 the discussion about limited liability revolved around economic and social arguments.

The law of unlimited liability was severely criticized. J. Stewart stated that the law of unlimited liability acts as a "bugbear" to respectable persons being connected with associations of a nature which might be productive of great public good and might produce considerable profit⁹⁸. According to T. Lietch, "the present law prevents the combinations of small capitals and moderate capitals together, which might otherwise take place for useful purposes"⁹⁹. R.G.C. Fane, a Commissioner in Bankruptcy, argued that the present law almost forces a person to be a creditor instead of a contributor, and in consequence, instead of contributing a certain amount towards the payment of the debts of the concern, he takes out the same amount as a creditor of the concern; he wondered, "why should the law be so harsh against contributors, and so tender to creditors"¹⁰⁰.

It was widely considered that a new law of limited liability would work advantageously for the investing public. It would give the investor "the advantage of a division and distribution of his capital, so that he would not be so likely to put it all in one concern"¹⁰¹. It would encourage

94. Ibid.

95. Ibid., pp. 7-8.

96. Ibid., p. 9.

97. Ibid.

98. Ibid., pp. 92-96.

99. Ibid., p. 180.

100. Ibid., pp. 114, 120.

101. Per T. Lietch, *ibid.*, p. 188.

wealthy as well as investors with moderate means to invest any portion of their property in undertakings of a public character without being exposed to the risks of personal insolvency.

The resulting combination of large and small shareholders, and of enterprise and capital¹⁰² would have the most favourable effects for the community. Local enterprises such as waterworks, gasworks and other public undertakings would be assisted by the investments of middle and working classes and would be enabled to play a crucial role for the development of the local economies¹⁰³.

Under the law of unlimited liability, it was experienced that "great destruction of property has followed from this reckless system of raising money upon the shareholders' credit and unlimited liability, money having been expended in speculations which would never exist had it not been for such facility"¹⁰⁴. Therefore, the introduction of limited liability should be accompanied by regulations "necessary to secure the public from falling into error by being led to believe that partners who have only a limited liability, are liable to the whole extent of their property"¹⁰⁵. As it was argued, "it is better for the public to rely upon the paid-up capital which they certainly know than upon the unlimited liability of the parties where the capital is not paid-up"¹⁰⁶.

There were also arguments against limited liability. Some participants considered that there was no need for an incentive to invest such as limited liability. W. Hawes, who was engaged in trading transactions in the City of London, witnessed that he was not aware of any enterprise offering a fair rate of profit being stopped by want of capital, on account of the law of unlimited liability¹⁰⁷.

W. Cotton, who had been Governor of the Bank of England, argued that an enterprise "is stopped by want of capital only when it does not hold out any certainty as to a profitable result"¹⁰⁸; he considered that there was "no really valuable discovery which a person cannot

102. "Everything which is calculated to unite enterprise and capital, instead of keeping them separate, is a good thing for the community." R.G. Fane, *ibid.*, p. 112.

103. See answers of J.G. Phillimore, *ibid.*, pp. 50-51.

104. T. Lietch, *ibid.*, p. 185; see also p. 181.

105. J. Stuart Mill, *ibid.*, p. 204.

106. T. Lietch, *ibid.*, p. 187.

107. *Ibid.*, p. 158.

108. *Ibid.*, p. 138.

find money to follow up"¹⁰⁹. He also argued that limited liability "would induce parties to advance their money without due caution for speculative schemes and speculative business which, although in some cases generally successful, would ultimately be found detrimental to the fair trader and to men who conduct their business with prudence and caution"¹¹⁰. The same view was shared by H.B. Ker, who alleged that "anything which encourages the investment of the capital of the middle classes in hazardous or doubtful undertakings is inexpedient"¹¹¹.

In the same context, it was argued that within a partnership *en commandite*, sleeping partners with limited liability could enter into the most speculative and uncertain transactions by putting into managing positions persons expected to act at their command. Sleeping partners could also ensure for themselves division of profits even when the concern was almost insolvent, by the use of manipulative accounting techniques. In this case, because the personal assets of the managing partners would possibly be insignificant, the creditors could suffer serious losses¹¹².

To cope with the problem, G.R. Porter, the Chairman of the Committee proposed that, in the event of the insolvency of the business, every partner should be liable to account and to bring back into the concern for the benefit of the creditors all the profits (save a proportion equal to a moderate rate of interest) which he might have taken out during a certain number of years preceding the failure, together of course, with any part of his registered capital which he may have withdrawn¹¹³.

In sum, the Committee of 1851 dealt extensively with the merits of limited liability. Limited liability was considered useful, mainly for two reasons:

1. For encouraging investors of various degrees of wealth to participate in economic activity and, therefore, to improve their economic and social condition; and

109. *Ibid.*, p. 142.

110. *Ibid.*, p. 136.

111. *Ibid.*, p. 210.

112. "One of the main things to be guarded against will be the exercise of an improper influence by the partners of limited liability over the managing partners of the concern. Partners of limited liability may be pressing for a division of money as profits where no profits have in fact been made, when by so doing they hazard only a small stake in a concern; and by a few such divisions they might secure themselves from loss, though the concern proved insolvent."; "it might not be possible always to prove the abuse since it would be easy to put such valuations upon outstanding ventures or speculations as to justify, by means of clever accountancy, any excessive divisions"; "...the great check on imprudent speculation is removed if only one who may be a man of straw is answerable *in solidum*." Replies by E. Holroyd, Commissioner of Bankrupts, G.R. Porter, Chairman of the Committee on the Law of Partnership and by Lord Brougham, *ibid.*, pp. 206, 208, 214, respectively.

113. *Ibid.*, p. 209.

2. For encouraging investment in public concerns to the benefit of the community as a whole.

On the other side, it was argued that the introduction of limited liability might generate two unwanted practices:

1. Speculation, in the form of undertaking risky and uncertain projects under the protection of limited liability; and
2. Fraudulent schemes, in the form of carrying on business through nominees acting at the command and to the benefit of partners with limited liability.

v) The report of 1854

a. The report

Because of the divergence of the opinions as to the expediency of introducing the partnership *en commandite* model into English law, this issue was not finally resolved by the Committee of 1851. A recommendation was made that it should be referred to a Royal Commission of "adequate legal and commercial knowledge"¹¹⁴. Accordingly, in 1854, a Royal Commission was appointed in order to "inquire and ascertain ... whether any and what alterations and amendments should be made in the law of partnership, as regards the question of limited or unlimited responsibility of the partners"¹¹⁵.

The main feature of the Royal Commission of 1854 was the divergence of the views expressed. It was reported that "it is difficult to say on which side the weight of authority in this country preponderates"¹¹⁶.

Nevertheless, the Commission concluded that the proposed alteration of the law would not operate beneficially on the trading interests of the country. The Commission regarded that an alteration of the law providing for limited liability of the partners was not necessary since its members "have not been able to discover any evidence of the want of a sufficient amount of capital for the requirements of trade; and the annually increasing wealth of the country, and the difficulty of finding profitable investments for it, seem to them sufficient guarantees that an

114. *Ibid.*, p. 8.

115. 1854 B.P.P., Vol. XXVII, p. 447.

116. *Ibid.*

adequate amount will always be devoted to any mercantile enterprise that holds out a reasonable prospect of gain, without any forced action upon capital to determine it in that direction"¹¹⁷.

Furthermore, the Commissioners expressed their anxiety that "any such forced action would have a great tendency to induce men to embark in speculative adventures to an extent that would be dangerous to the interests of the general commerce of the country"¹¹⁸. Even those of the opinions which were in favour of the introduction of limited liability were sometimes "coupled with a recommendation of more stringent regulations than those now existing for the prevention of fraud"¹¹⁹. It was pointed out that "if such partnerships [with limited liability] would increase the danger of fraud, they can hardly be otherwise than prejudicial to our mercantile reputation"¹²⁰.

According to the report, the only circumstances where limited liability might have positive effects were i) "in useful enterprises calculated to produce benefit to the public and profit in those engaged to them", since "they are of such magnitude that no private partnership can be expected to provide the funds necessary to carry them into effect, or to have the means of superintending and managing them" (docks, railways), and ii) in "others of a more limited character from which benefit to the humbler classes of society may be expected to accrue (baths, wash houses, reading rooms), to the establishment of which by large capitalists there is little inducement"¹²¹. In these circumstances, limited liability ought to be granted by an Act of Parliament or a charter.

In concluding their Report, the Commissioners took care to stress that "although the details of our mercantile laws may require correction, yet while there is on every side such abundant evidence of satisfactory progress and national prosperity, it would be unwise to interfere with principles which have proved beneficial to the general industry of the country"¹²².

117. *Ibid.*, pp. 447-448.

118. *Ibid.*, p. 448.

119. *Ibid.*

120. *Ibid.*

121. *Ibid.*

122. *Ibid.*, pp. 449-450.

b. The discussion

Once again, the main subject under consideration was the introduction of the partnership *en commandite* model in English law. A great deal of emphasis was placed on the negative consequences of limited liability. There was a widespread conviction that creditors would suffer from the introduction of the limitation of the partners' liability.

Lord Curriehill, who, alongside with others, held the view that proposals for the introduction of limited liability in the form of the partnership *en commandite* could not safely be adopted, identified clearly the two potential sources of detriment to the creditors:

1. Creditors would be defrauded where they allowed credit to a partnership *en commandite* without their being made aware that some of the partners - probably the only ones of substance - had acquired an immunity from their legal liability to pay the price¹²³.
2. "It would often happen at the time when funds are acquired by such a company on credit, the in-put capital which it is proposed to substitute for the joint liability of the partners would have previously ceased to exist ... [t]here is no security that stock is in existence at the time when debts are contracted ... [i]t is experienced that it is usual to begin business without the stipulated capital being bona fide paid and still more easy to withdraw it in the name of profits"¹²⁴.

R. Slater contended that creditors would have "no means of ascertaining that the limited partnership has not obtained credit to the extent of a hundred times the amount of its actual capital"¹²⁵. On this particular point, J.G. Hubbard, the contemporary Governor of the Bank of England, pointed out that "where unlimited power of borrowing exists, unlimited liability should attach"¹²⁶.

According to G.W. Norman, a director of the Bank of England, all those against the introduction of limited liability were "terrified by a set of phantoms, the creatures of their own imaginations"¹²⁷. J.S. Mill emphatically declared that "the supposed tendency of limited

123. *Ibid.*, p. 457.

124. *Ibid.*, pp. 458-459.

125. *Ibid.*, p. 487.

126. *Ibid.*, p. 563.

127. *Ibid.*, p. 611.

partnerships to stimulate undue credit is a charge which may be brought, far more truly, against the principle of unlimited liability"¹²⁸.

T.M. Weguelin, who was the Deputy Governor of the Bank of England, argued that the system of unlimited liability not only was no impediment to, but it actually caused the most gigantic abuses of credit. On the advantages of limited liability, he said the following:

"A law of limited liability would have a tendency to substitute in business concerns, responsible capital in place of credit. It is clear that the credit of a partnership of limited liability will be limited also, and will be governed by the security afforded by the known capital, and not by a vague estimate of property supposed to exist independently of the business, which in nine cases out of ten has no existence at all, or only a delusive existence"¹²⁹.

G.W. Bramwell argued that a creditor should be aware of the nature of speculation and should charge accordingly the use of the capital lent. If he had not inquired and suffered losses, it was his own fault. For the case, though, where he had inquired and he had been misinformed, the only solution would be a registry where all the particulars of the company should be lodged¹³⁰.

The possible effects of the proposed alteration on the position of shareholders were also considered. As Hunt observes, the typical shareholder was approached more as a mere purchaser of income than an entrepreneur in the full sense of the word¹³¹. To Lord Hobard, it was but natural justice that a partner with an active share in the management of a business should be held liable for the firm's engagements. But since the ordinary member or shareholder had no part in management whatsoever, the law was in error and unjust in making him fully liable¹³².

W. Thomson, referred to trust fund investors as an example of unjust application of unlimited liability. As the shares in joint-stock associations were increasingly being held by trust fund investors whose actual control over the management was increasingly diminishing, he

128. *Ibid.*, p. 679.

129. *Ibid.*, pp. 565-566; see also the opinion of K.D. Hodgson, *ibid.*, pp. 477-480.

130. *Ibid.*, p. 467.

131. B. HUNT, *op. cit.*, p. 130.

132. Remarks in the Law of Partnership Liability, 1853, quoted in B.C. HUNT, *op. cit.*, p. 131.

considered "only fair to secure these parties [the trust fund investors] from any further loss than the sum actually invested"¹³³.

However, despite the arguments in favour of the introduction of the proposed alteration, the Commissioners felt reluctant to recommend it. Many opinions revealed a prejudice against any changes to the existing legal regime. G.W. Bramwell, giving his opinion to the Committee in favour of limited liability, expressed the view that the judgement of those against it was "influenced by their natural satisfaction with things as they find them and a wish they should not interfere with"¹³⁴, while J. Anderson did not hesitate to hold that "change is undoubtedly in itself an evil", and "it is unwise to disturb rules or principles which have taken root to our system, and which are familiarly known to those transactions or conduct they are to regulate"¹³⁵.

Nevertheless, the Committee of 1854 went a step further than its predecessors. Without ignoring the sociological dimension of the proposed alteration, many of the participants focused on more legal and economic arguments. It was openly suggested that limited liability, apart from benefiting the middle and the lower classes of the society, would:

1. Facilitate raising of capital by concerns intending to carry out operations which could not be undertaken by small partnerships; and 2. Protect those investors who were not in a position to control the management of the firm; their inability to control the company should be accompanied with their limited liability for the company's losses.

vi) Subsequent developments

In spite of the fact that the 1854 report was against limited liability, the Government, according to a motion passed in the House of Commons, introduced a Bill which obtained the Royal Assent in 1855 and became the Limited Liability Act.

The Limited Liability Act of 1855¹³⁶ provided for limited liability of the members of a registered company under certain conditions designed for the protection of the creditors and the public. Specifically, it provided for the limited liability of the members of a company on complete registration if (a) the company had at least 25 members holding shares paid up to the

133. Report of 1854, *op. cit.*, p. 518.

134. *Ibid.*, p. 466.

135. *Ibid.*, p. 472.

136. 18 & 19 Vict. c. 133.

extent of at least 20 per cent., (b) not less than three fourths of the nominal capital was subscribed, (c) the word "Limited" was added to the company's name, and (d) the Board of Trade approved a report on the affairs of the company¹³⁷.

In 1856, the 1855 Act was incorporated in the Joint Stock Companies Act¹³⁸ which repealed most of the protective provisions but left unamended the one providing for personal liability of a director who had authorized dividend payments notwithstanding that he knew of the company's insolvency¹³⁹. All that the Act of 1856 required was the registration of a memorandum signed by seven or more persons and that the word "Limited" should follow the name of the company as warning to third parties.

By the Act of 1855 and, eventually, of 1856¹⁴⁰, limited liability was finally extended to registered companies although all the previous discussions were about partnerships and especially about the expediency of introducing a mixed form of limited and unlimited liability similar to the French *commandite* model. Limited liability in the absolute form which was actually enacted was scarcely discussed and it is estimated that only 15 witnesses out of 70 who took part in the 1854 proceedings were in favour of it¹⁴¹.

This dramatic change in the attitude towards limited liability is mainly attributed to the pressure exercised by the press as well as to the predominance of *laissez faire* arguments. The *Times*, which was always against limited liability, reversed its position in 1855:

"Who are they in a Christian Community who insist that the law between debtor and creditor shall always be of this murderous character ... that there shall be not only forfeiture of the sum expressed in the bond, but of everything else the debtor has in the world?"¹⁴²

The *Economist* was also against unlimited liability:

137. *Ibid.*, ss. i, ii; see L.C.B. GOWER, *op. cit.*, p. 45.

138. 19 & 20 Vict. c. 47.

139. Limited Liability Act 1855, *op. cit.*, s. ix; for the full text, see below, ch. VII, B, ii, a.

140. For a contemporary comment on the Act, see *Economist*, vol. XIV (1856), p. 699.

141. H. A. SHANNON, *op. cit.*, p. 284.

142. July 28, 1855.

"The law is so much at variance with the actual practices of life, that Parliament and The Crown and individuals are continually obliged to put it aside. The law is, in principle and practice a bad law."¹⁴³

Advancing the *laissez faire* argument, Robert Low, who was then President of the Board of Trade, stated the following:

"I am arguing in favour of human liberty - that people may be permitted to deal how and with whom they choose, without the officious interference of the State ... the principle we should adopt is this, - not to throw the slightest obstacle in the way of limited companies being formed - because the effect of that would be to arrest ninety-nine good schemes in order that the bad hundredth might be prevented..."¹⁴⁴

He further argued that the only way in which the Legislature should interfere is by giving the greatest publicity to the affairs of such companies, so that every one may know on what grounds he is dealing¹⁴⁵. The value of publicity was also stressed in an article in the *Economist*:

"In our country, the two elements of freedom and publicity are all that is required to make traffic successful and ensure its honesty. It will be for the advantage of individuals engaging in partnership concerns or forming companies, to make known the conditions of their partnership. Without that they will obtain no confidence beyond the circle of those who know them intimately."¹⁴⁶

The contribution of limited liability to the subsequent increase in promotions was considerable. It is estimated that, in the ten years following the 1856 Act, no fewer than 5,420 companies were registered whereas in the twelve years before 1856, only 956 companies were registered under the 1844 Act¹⁴⁷. However, in the years following the adoption of the 1862 Act, which, in general, restated the earlier statutes, there occurred what has been described as the most severe panic in the history of the London financial community¹⁴⁸. A wave of speculative and

143. Vol. XII, 1854, p. 698; see also L.C.B. GOWER, *op. cit.*, p. 44, fn. 49.

144. Hansard CXL, 1856, col. 131.

145. *Ibid.*

146. Vol. XIII, 1855, pp. 84-85.

147. H. A. SHANNON, *The first five thousand Limited Companies*, 1932, *Econ. Hist.*, p. 396 at 420-421.

148. B.C. HUNT, *op. cit.*, pp. 153-155.

fraudulent schemes verified, to a certain extent, the warnings of those who had been opposed to the introduction of limited liability.

C: THE EXPERIENCE OF OTHER COUNTRIES

i) United States¹⁴⁹

In the United States, because charters and incorporating acts were made more readily available to businessmen, incorporated companies were the norm rather than the exception¹⁵⁰. As early as in the beginning of the nineteenth century charters were easily granted not only to financial institutions and companies of public function, but to manufacturing companies, as well¹⁵¹.

However, grant of incorporation was not always accompanied by limitation of liability. Charters often provided for unlimited liability, either directly or indirectly through the power of the company to levy assessments without limit on shareholders¹⁵². Statutes, also, were inconsistent, sometimes providing for limited liability and sometimes otherwise¹⁵³.

However, the rapid economic growth and the resulting need for capital in industries such as the railways and manufacturing companies exercised considerable pressure for the general adoption of limited liability in almost all the states. In response to these pressures, both the courts and the legislature made significant steps towards the general acceptance of limited liability.

Thus, by the end of the first quarter of the nineteenth century, it became accepted law in several states that shareholders were not directly and, in some states, not even indirectly, liable for corporate debts unless the charter or statute expressly so provided. During the same period, many states enacted statutes providing for limited liability in manufacturing companies¹⁵⁴.

149. See PH.I. BLUMBERG, *The Law of Corporate Groups: Tort, Contract and other Common Law Problems in the Substantive Law of Parent and Subsidiary Corporations*, 1987, pp. 23-38.

150. See PH.I. BLUMBERG, *ibid.*, p. 24; L.C.B. GOWER, *Some Contrasts between British and American Corporation Law*, 69 *Harv. L. Rev.*, 1956, p. 1369 at 1372.

151. PH. I. BLUMBERG, *ibid.*, pp. 24-25.

152. *Ibid.*, pp. 25-28.

153. *Ibid.*, pp. 41-51.

154. PH.I. BLUMBERG, *op. cit.*, pp. 31-35.

Thereafter and notwithstanding the repeated attempts to revive unlimited liability¹⁵⁵, limited liability became generally accepted.

But the fact is that for many years incorporated companies were operating in the US with unlimited liability. Early American statutes provided variously for limited liability, double liability, or unlimited liability. In Blackstone's list of the five attributes or powers "inseparably incident to every corporation" limited liability was not even mentioned¹⁵⁶. It is significant that until 1928, the shareholders of California corporations did not enjoy limited liability and even nowadays Delaware permits unlimited liability corporations¹⁵⁷.

Hence, like its English counterpart, American law did not introduce limited liability as an indispensable attribute of incorporation. It was only due to economic considerations that limited liability was finally introduced. As it is felicitously pointed out, the establishment of limited liability in the United States as well as in England "while not necessarily a requirement of the concept of separate entity, represents a definite political and economic choice, in some cases codified by statute, and constitutes a clear statement of policy"¹⁵⁸.

ii) Continental European Countries

In France, incorporation through charter follows the history of its English counterpart; charters were predominantly granted to companies established for colonization purposes. It is estimated that before 1789 more than 70 such companies were chartered¹⁵⁹. But the outburst of speculation which occurred in 1720 and led to the English Bubble Act, led to similar legislation in France in order to limit the formation of public companies. However, chartered companies continued to be formed and it was only a few years before the Revolution that they were almost all abandoned¹⁶⁰.

155. *Ibid.*, p. 37.

156. See H.G. HENN & J.R. ALEXANDER, *Laws of Corporations and Other Business Enterprises*, 3rd ed., 1983, pp. 147-148.

157. Delaware Corporation Law, s. 102(b)(6); see also New York Business Corporation Law, para. 630 on the liability of the largest shareholders for wages.

158. T.W. CASHEL, *Groups of Companies - Some US Aspects*, in CL. SCHMITTHOFF & FR. WOOLDRIDGE (ed.), *Groups of Companies*, 1991, p. 20 at 25.

159. W. MINCHINTON, *op. cit.*, p. 141.

160. *Ibid.*, pp. 144-145.

Although the directors of the French East India Company appear to have been protected by limited liability, limited liability clauses were included in charters only after 1780. It seems that, previously, shareholders had unlimited liability¹⁶¹.

On 1 January 1808, the Napoleonic *Code de Commerce* came into force. The Code recognized three forms of business organization: the *société en nom collectif*, a partnership with unlimited liability, the *société en commandite*, a limited partnership with at least one sleeping partner with limited liability and at least one managing partner with unlimited liability and the *société anonyme*, a limited liability company suitable for large scale enterprises.

Although with limited liability, *sociétés anonymes* could not be freely incorporated. They had to present their constitutional documents for authorization by the government. Until 1867, when free incorporation became possible, 642 proposals were accepted, mainly for road, canal and bridge schemes, mining companies, public utilities, banks and insurance companies¹⁶². In sharp contrast, only in the years between 1868 and 1876, 798 *sociétés anonymes* were incorporated in the Paris area alone¹⁶³.

Influenced by the French *Code de Commerce*, several European countries introduced limited liability into their statutes, concurrently or even before the statutory introduction of general incorporation¹⁶⁴. The first German General Commercial Code, for instance, made the form of the joint stock corporation with limited liability (AG) available to business undertakings as late as 1861, although corporations started to be formed after the middle of the eighteenth century. The law relating to private limited companies was enacted even later, in 1892¹⁶⁵.

Thus, like in England and in the United States, in Continental Europe limited liability was not introduced as an attribute of the concept of the corporation as a separate entity. It emerged as a direct consequence of economic evolution.

161. C.E. FREEDEMAN, *Joint Stock Enterprises in France 1808-1867: From Privileged Company to Modern Corporation*, 1979, p. 5.

162. W.E. MINCHINTON, *op. cit.*, p. 147.

163. C.E. FREEDEMAN, *op. cit.*, p. 144, cited in W.E. MINCHINTON, *ibid.*, pp. 147, 158.

164. PH. I. BLUMBERG, *op. cit.*, 38-39; A. CONARD, *Company Laws of the European Communities from an American Viewpoint*, in CL. SCHMITTHOFF (ed.), *Harmonization of European Company Law*, 1973, p. 45 at 46.

165. K. MACHARZINA, *Corporate Forms and Limited Liability in German Company Law*, in T. ORHNIAL, *op. cit.*, p. 44 at 47-49.

D: CONCLUSION

From the foregoing discussion on the origins of limited liability, it appears that there is not a substantial legal association between the concept of the corporate personality and the rule of limited liability.

Incorporated companies existed and operated much before the general introduction of limited liability. The limitation of their members' liability was not a consistent feature. Limited liability was generally introduced only when the change of the law was considered a matter of social and economic necessity. As Henn and Alexander point out, "limited liability developed as a sort of afterthought"¹⁶⁶.

Limited liability was intended to operate as an additional incentive for investment in concerns of such social importance and economic magnitude that wide participation was considered necessary for their successful operation. It was hoped that limited liability would stimulate investment in these concerns by encouraging contribution of capital without active participation in the management. Indeed, the introduction of limited liability made it possible for a great number of investors to contribute a certain portion of their wealth to a company and to abstain from its management without risking the rest of their wealth.

Therefore, it may safely be concluded that limited liability does not constitute a necessary attribute of corporate personality; it is not a sort of legal postulate indispensable from the concept of the company as a separate legal person. As a legal means of achieving social and economic goals, it is applied and should be applied only in cases where the achievement of such goals is legitimate and feasible. Where this does not happen, limited liability serves no real purpose but it merely constitutes an unreasonable adherence to an unfounded legalism.



¹⁶⁶ Op. cit., p. 19.

CHAPTER II: THE SIGNIFICANCE OF LIMITED LIABILITY FOR THE SINGLE COMPANY

As it was demonstrated in the previous chapter, limited liability was by no means introduced as a necessary attribute of incorporation but as a legal norm useful for the achievement of certain socio-economic purposes. Specifically, limited liability was introduced in order to involve more people in economic activity and to attract large amounts of capital in concerns that could not operate efficiently without wide participation from the investing public.

Since the application of limited liability primarily serves socio-economic purposes, it constitutes an optimal legal solution only when these purposes are really served. When, due to various reasons, limited liability cannot contribute to the achievement of these purposes, it is no more an optimal legal rule and its application should be reconsidered.

It is the thesis' central argument that limited liability is not the optimal liability rule in the context of groups of companies. The distinctive features of a group of companies are such that render the application of limited liability ineffective; within the typical group of companies, the purposes of limited liability cannot be pursued. Therefore, it is necessary to consider the application of an alternative liability rule which will be more responsive to the specific features of the group.

In order to establish the unsuitability of limited liability for groups of companies, this chapter will focus on the economic significance of limited liability in the context of the single independent company; subsequently, the conclusions reached will be tested within the framework of the typical group of companies¹.

1. Farrar stresses at the close of his chapter on groups of companies that, in order to review the issue of the necessity of limited liability for groups, it will be "necessary to go back to basics and ask what are the underlying economic purposes of limited liability and to what extent do they require the doctrine to apply to groups of companies". J.H. FARRAR, N. FUREY, B. HANNIGAN, *Farrar's Company Law*, 3rd ed., 1991, p. 545; see above, Introduction, fn. 12.

For the purposes of the following analysis, limited liability means that the shareholder is under no obligation to the company or its creditors beyond his obligation on the par value of his shares². We define unlimited liability as the rule under which the shareholders can be called, either by the company or directly by the creditors to contribute towards the payment of the company's debts with all their personal wealth, if required.

A. THE ECONOMIC FUNCTIONS OF LIMITED LIABILITY

i) Limited liability as an incentive to investment

It is significant that, while the Limited Liability Act of 1855 provided for limited liability companies consisting of at least 25 members, the subsequent Joint Stock Companies Act of 1856 reduced this requirement to seven members, and the Salomon case³ virtually reduced it to one. The Companies (Consolidation) Act of 1908 introduced the public/private dichotomy with the membership of the private company being limited to 50 while other legal systems very early provided for limited liability for private companies consisting of a few number of members, as for the French *société à responsabilité limitée* (SARL)⁴ and the German *Gesellschaft mit beschränkter Haftung* (GmbH)⁵.

However, the economic significance of limited liability can be properly assessed only when limited liability is looked at as it is applied in its original environment, that of the large public corporation. This is because, as is historically evidenced, the main purpose behind the introduction of limited liability was concentration of capital by as many members of the investing community as possible. Thus, we are bound to make a logical deduction and to concentrate on the application of the rule in the archetypal public limited liability company. This company was a genuine consequence of economic evolution whereas the legal forms for companies consisting of a few members were artificial creations of the legislature⁶.

2. J.H. FARRAR, N.E. FUREY, B. HANNIGAN, *Farrar's Company Law*, 3rd ed., 1991, p. 82.

3. [1897] A.C. 22, H.L.

4. The French Law of 7 March 1925.

5. The German Private Limited Companies Act 1892.

6. See B.W. MEISTER, *The Limited Liability Company*, in B. RUSTER (ed.), *Business Transactions in Germany*, Vol. 2, 1991, ch. 23, p. 10; A. ROJO, *The Typology of Companies*, in R.R. DRURY & P.G. XUEREB (ed.), *European Company Laws*, 1990, p. 41 at 48-49; C.M. SCHMITTHOFF, *How the English Discovered the Private Company*, in P. ZONDERLAND (ed.), *Quo Vadis, Jus Societatum?* 1972, p. 183.

In the archetypal public limited liability company, the economic significance of limited liability lies primarily in its function as an incentive to invest. In this type of company, shareholders, due to the widespread distribution of shares, do not have the practical ability to participate in the management. Making the shareholder personally liable in these circumstances would be a serious deterrent to investment; it would be unwise for the investor to buy shares in a company since he may always end up losing his entire personal property because of the mismanagement of others.

Limited liability makes it possible for the shareholder to abstain from participating in the management of the company while he is liable only for the sum of his investment. Thus, the shareholder becomes able to determine the potential extent of his maximum loss and the company becomes able to undertake worthwhile ventures which might not have been undertaken without limited liability. In effect, investment and risk-taking are greatly encouraged⁷.

However, the economic significance of limited liability lies not only in its function as an incentive to invest, but, also, in its cost-minimizing as well as in its risk-shifting function. By cost-minimizing function we refer to the contribution of limited liability to the minimization of costs involved in the operation of the company, i.e to economic efficiency⁸. By risk-shifting function we refer to the consequences of limited liability for the company's creditors.

ii) Cost-minimizing function

a. Separation costs

Because the management of the typical limited liability corporation under consideration (i.e. the large public company) cannot be effectively exercised by the members themselves, managerial duties are delegated to a specialized body with the task of performing them in a quick and flexible way. As a result, it becomes "part of the basic structure of the capitalist system and of company law that directors and managers shall have exclusive control over the management of a company's affairs, both on a day-to-day basis and in terms of general policy"⁹.

7. PH.I. BLUMBERG, *The Law of Corporate Groups: Tort, Contract and other Common Law Problems in the Substantive Law of Parent and Subsidiary Corporations*, 1987, p. 67.

8. Defined as the relationship between the aggregate benefits of a situation and the aggregate costs of the situation. See A.M. POLINSKY, *An Introduction to Law and Economics*, 1983, p. 7.

9. T. HADDEN, *Company Law and Capitalism*, 2nd. ed., 1977, p. 78. H.G. MANNE (*Our Two Corporation System, Law and Economics*, 53 *Virginia Law Review* 2, March 1967, p. 259 at 260-261) points out that "...the first important legal norm which can be derived from the central concept of the corporation as a capital raising device is that of centralised management, which has been virtually sanctified in the classical words of every state's corporate statute: The business of the corporation shall be managed by the board of its directors." For the issue of control, see also J.H. FARRAR, *Ownership and Control of Listed Public*

The general meeting of shareholders retains some residual powers such as the right to alter the memorandum and the articles¹⁰, to decide alterations to the capital structure¹¹ and other non-statutory rights conferred by the articles.

The separation of function between owners and managers of the company results in a divergence of interest. Shareholders, with the exception, perhaps, of institutional investors¹², assume a passive role and are mainly interested in the maximization of return for their investment and only incidentally, in the prosperity of the company as an enterprise¹³. On the other side, the management, when it does not hold shares¹⁴, is primarily interested in securing the existence of the company as their source of living and as a matter of prestige¹⁵.

Thus, there is a potential conflict between the interests of managers and shareholders¹⁶. Managers may have the tendency of giving priority to their self-interest and to ignore the interests of shareholders. Since their payment is not directly associated with the maximization of return for the shareholders, they do not necessarily have a reason to pursue a return-maximizing policy¹⁷, if this is not in accordance with their own interests.

In order to protect their interests, shareholders supervise and control the activities of the management by establishing auditing schemes, by placing budget restrictions or by offering

Companies: Revising or Rejecting the Concept of Control, in B. PETTET (ed.), *Company Law in Change*, 1987, p. 39.

10. CA 1985, ss. 4 and 9.

11. CA 1985, ss. 121 and 135.

12. See J.H. FARRAR, N.E. FUREY, B. HANNIGAN, *op. cit.*, pp. 10-11 and 592-604.

13. "For the most part, the shareholders in the major oil companies, in General Motors, in ICI, and in other world-class corporations are more truly described as investors than as owners, looking for a decent return on their capital and a moderate hope of its growth, but having no influence - nor desiring it - on the way "their companies" are run." W.J. READER, *Versatility Unlimited: Reflections on the History and Nature of the Limited Liability Company*, in T. ORHNIAL (ed.), *Limited Liability and the Corporation*, 1982, p. 191 at 201.

14. In his research into the control characteristics of the top 10 listed United Kingdom companies by market capitalization in 1984, Farrar found out that personal holdings of directors are very low. See *Ownership and Control of Listed Public Companies: Revising or Rejecting the Concept of Control*, *op. cit.*, pp. 48-51.

15. See T. HADDEN, *Company Law and Capitalism*, *op. cit.*, p. 76.

16. For the evolution of this conflict and the judicial attitude of English Company Law, see H. RAJAK, *A Sourcebook of Company Law*, 1989, pp. 495-516.

17. "Instead of seeking exclusively to increase the net return on capital invested, those in control of company decisions will also be concerned with the preservation of the company and its business, and of their own control over it, with growth and "empire-building" in order to increase the range and extent of their power and thus reduce the uncertainty of their operations, and even with increasing their own personal prosperity rather than that of their shareholders." T. HADDEN, *op. cit.*, p. 81.

managers incentives to work for the shareholders' interests¹⁸. These measures are not costless. They generate the so called agency or separation costs¹⁹.

The application of limited liability greatly affects the extent of these costs. In fact, an essential advantage of limited liability stems from the fact that it reduces the costs involved in the separation between the ownership and the management of a company. Shareholders with limited liability are not under a great pressure to assume the costs of monitoring the management since their maximum loss is confined to the amount of their subscription to the company's capital; in any event, they are expected to protect their position by spending less than they would spend if their entire property was at risk²⁰. As one writer characteristically says, the company with limited liability was designed mainly so that investors "might sleep more easily at night, their rest less frequently disturbed by dreams of bankruptcy and destitution"²¹.

On the contrary, under a rule of unlimited liability, shareholders would be expected to spend a considerable amount of money and time in supervising and monitoring the management's activities. Since the company's failure might generate the loss of the shareholder's entire personal property, "to be a sleeping partner, without limited liability, would be exceedingly dangerous"²². Therefore, under an unlimited liability scenario, supervision of management would become a more expensive exercise, since the more risk investors bear, the more they will wish to monitor²³.

b. Information Costs

Shareholders have a strong interest to be aware of all the facts and circumstances, present and future, that might affect their position. The earning power of the company, its capitalization, the identity and the wealth of the other shareholders, are all data that a shareholder may want

18. "Separation is efficient, and indeed inescapable, given that for most shareholders the opportunity costs of active participation in the management of the firm would be prohibitively high. What is necessary in the interests of shareholders is not participatory shareholder democracy but machinery for discouraging management from deflecting too much of the firm's net income from the shareholders to itself." R. A. POSNER, *Economic Analysis of Law*, 3rd ed., 1986, p. 384.

19. The issue of agency costs is extensively discussed in M.C. JENSEN & W.H. MECKLING, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, 3 *Journal of Financial Economics*, 1976, p. 305.

20. See F.H. EASTERBROOK & D.R. FISCHER, *Limited Liability and the Corporation*, 52 *U. Chi. L. Rev.* 1985, p. 89 at 94-95.

21. W. READER, *Versatility Unlimited: Reflections on the History and Nature of the Limited Liability Company*, in T. ORHNIAL (ed.), op. cit., p. 191.

22. J. HICKS, *Limited Liability: the Pros and Cons*, in T. ORHNIAL (ed.), op. cit., p. 11.

23. See P. HALPERN, M. TREBILCOCK, ST. TURNBULL, *An Economic Analysis of Limited Liability in Corporation Law*, 30 *Univ. of Tor. L. J.*, 1980, p. 117 at 125.

to know. To obtain the relevant information shareholders have to incur the necessary costs. The extent of these costs will greatly depend upon the kind of the liability rule.

Under the rule of limited liability, present and future shareholders know that their return depends on the number of the shares held as well as on the earnings of the company; their maximum loss is limited to the amount which they have invested in the company. Therefore, to form an accurate picture of the value of their investment, it suffices for them to obtain the information about all these possible outcomes of the company's operation that will affect the company's profitability and, consequently, the return on their investment. This information will mainly relate to "the earnings outcomes given the existing set of assets and the impact of new investments on these earnings"²⁴. Information about the identity and about the wealth of the other shareholders is not necessary.

On the contrary, under a rule of unlimited liability, a shareholder may be called upon to contribute towards the payment of the company's debts not only with any unpaid amount of subscribed capital but, in addition, with his entire personal property. If the sum of the personal properties of the other shareholders is well above the sum of the liabilities that the company has incurred, the loss of the individual shareholder is unlikely to be significant. If, however, he is the only one with sufficient wealth, he faces the risk that he will have, alone, to meet the liabilities of the company.

Therefore, under unlimited liability, present and future shareholders are not expected to confine themselves to an enquiry about the earning power of the company, but, in addition, they are expected to require information about the wealth levels of all the other shareholders. Moreover, "not only will they need to know the wealth levels at the point in time when they become owners but also at each moment in time in the future, since their financial responsibility in the event of a default may change as the composition of the owners change"²⁵. In any event, under a rule of unlimited liability, the information costs of shareholders would be significantly higher.

24. P. HALPERN, M. TREBILCOCK, ST. TURNBULL, *op. cit.*, p. 136.

25. P. HALPERN, M. TREBILCOCK, ST. TURNBULL, *op. cit.*, p. 136. See also, F.H. EASTERBROOK & D.R. FISCHER, *The Economic Structure of Corporate Law*, 1991, p. 42, hereinafter cited as F.H. EASTERBROOK & D.R. FISCHER II.

c. Securities Markets

Apart from minimizing separation and information costs, the application of the limited liability rule has a similar effect on the costs involved in the operation of securities markets and, thus, it promotes their efficiency.

Under limited liability, the price of the share depends, in addition to the other Stock Exchange factors such as the general economic and political conditions, on the performance of the company and on its prospects for the future; it does not depend on the personal wealth of shareholders since this wealth cannot be available to the company. Because the other factors are identical for all the shares of a company, these shares carry the same price and they can be traded as homogeneous commodities.

Thus, shares can be traded in a cheap and automatic way enabling the securities markets to operate efficiently²⁶. A shareholder who, for whatever reason wishes to sell his shares, has the opportunity to do so efficiently and to realize a profit soon after he bought them.

Under unlimited liability, however, shareholders are liable for the company's obligations with their personal property and their maximum potential loss depends on the wealth of the other shareholders. Therefore, the price that an investor is ready to pay for a company's shares is not only determined by the aforesaid factors, but, additionally, by the magnitude of his personal wealth compared with that of the other shareholders. A wealthy investor, because of the increased risk that he faces, will command a reduction of the share price²⁷. Consequently, the prices of a company's shares would not be identical and the efficiency of the securities markets would be greatly impaired²⁸.

The same conclusion is reached by Halpern, Trebilcock and Turnbull, although through a different line of argument. They contend that, under unlimited liability, a wealthy shareholder will tend to acquire a number of shares which will be sufficient to enable him to control the affairs of the company and, therefore, to protect himself from the possibility of losing his entire wealth. "Under this scenario, it is very likely that there will be a concentration of ownership

26. "When all can trade on the same terms, though, investors trade until the price of shares reflects the available information about a firm's prospects. Most investors need not expend resources on search; they can accept the market price as given and purchase at a "fair" price." F.H. EASTERBROOK & D.R. FISCHER, *op. cit.*, p. 96.

27. "The wealthy shareholder is providing a form of insurance to the other investors against losses in the event of default." P. HALPERN, ST. TREBILCOCK, M. TURNBULL, *op. cit.*, p. 130; "The greater the anticipated cost of this additional capital contribution, the less this investor would be willing to pay for shares." F.H. EASTERBROOK & D.R. FISCHER, *ibid.*, p. 92.

28. See F.H. EASTERBROOK & D.R. FISCHER II, *op. cit.*, pp. 42-43.

of the equity securities in the hands of the wealthy shareholders. Any securities not held by these wealthy shareholders would command a premium in the capital markets. However, it is unlikely that there would be active trading in the market due to the concentration of ownership." In the extreme, they argue, securities markets will not exist²⁹.

Blumberg objects to the argument that in the absence of limited liability securities markets would be unlikely to function efficiently, by recalling some historical data. He points out that the securities markets in England started flourishing long before the introduction of limited liability, when the popular vehicle to carry on a business was the unlimited liability joint stock association. He invokes the findings of Hunt according to which, as early as by the end of the seventeenth century there were properly functioning public markets all over England³⁰.

During that period, however, limited liability was not available to the overwhelming majority of concerns. Investors had no choice but to trade in the stakes of unlimited liability associations. The contribution of limited liability to the efficiency of the securities markets can be properly assessed only when one takes into account that, nowadays, organized securities markets in the form of stock exchanges exist, virtually, only for limited liability companies.

It seems, therefore, that limited liability is indispensable for an efficient securities market. Either because unlimited liability generates non-identical share prices and imposes substantial additional costs to new investors or because it leads to concentration of shareholdings in the hands of few wealthy shareholders, it is quite probable, that, in the absence of limited liability, trading in the securities markets would be devitalized.

d. The cost of the company's capital

Investment in shares is only one form of financing the operations of a company. Alternatively or concurrently, a company can be financed with loan capital. The investor is then called debenture holder or bondholder and he is not considered a member of the company. He is remunerated with a fixed rate of interest which must be paid before dividends are paid to shareholders and his claim for repayment of the debt ranks prior to the shareholders' claim in the event of the company's liquidation³¹.

29. P. HALPERN, M. TREBILCOCK, ST. TURNBULL, *op. cit.*, pp. 136-137.

30. PH. I. BLUMBERG, *op. cit.*, p. 71.

31. See J.H. FARRAR, N.E. FUREY, B. HANNIGAN, *op. cit.*, ch. 19, p. 252 *et seq.*

It has previously been suggested that a great advantage of limited liability lies in the fact that it stimulates investment in the form of subscription to the company's share capital³². If, however, instead of equity capital, a company could be financed by loan capital on terms equally advantageous, the importance of limited liability would have been under question. If the amount of equity investment that limited liability stimulates could be provided by bondholders on terms equally favourable for the company and irrespective of the liability rule for the shareholders, it could not have been argued that limited liability is "the greatest single discovery of modern times"³³ and "the means by which huge aggregations of capital ... were collected, organized and efficiently administered"³⁴.

The company's cost of raising equity capital under limited liability is lower than its cost of raising loan capital under any liability rule. The company's cost of raising capital is represented by the returns it has to pay to investors. There is a crucial difference between paying returns to shareholders and paying returns to bondholders. A company has to pay a fixed interest to bondholders whatever its financial situation may be. On the contrary, the dividend to shareholders has to be paid only when the company is in a sound financial condition and even then, only subject to the management's discretion.

A potential shareholder of a company is expected to take into consideration the risk of not receiving the dividend and to ask for appropriate compensation. That compensation will normally take the form of a reduction in the price of the share. In this case, the shareholder is fully compensated for the risk that there will be no return to his investment but the company receives less capital than could have been raised if investors were guaranteed a fixed return.

If, instead, the company is financed by loan capital, it has no discretion and it is obliged to pay the fixed interest in good and bad times alike. As a consequence, the bondholders are not expected to ask for *ex ante* compensation in the form of reduction of the capital provided because they are certain, or at least more certain than shareholders, that they will have a return on their investment.

32. See above, A, i.

33. Said by Nicholas Murray Butler, President of Columbia University in 1911, cited by R. MEINERS, J. MOFSKY and R. TOLLISON, *Piercing the Veil of Limited Liability*, 4 Del. J. Corp. L., 1979, p.351.

34. *Economist*, December 18, 1926, cited by B.C. HUNT, *The Development of the Business Corporation of England 1800-1867, 1936*, p. 116.

It seems, therefore, that a company financed entirely by shareholders is not in a better position than a company financed entirely by bondholders. The discretion of paying dividends to shareholders is outweighed by the lower amount of the capital received by them, while the higher amount of capital received by bondholders is outweighed by the obligation to pay the fixed interest.

Actually, however, the rule of limited liability enables the company to raise equity capital on terms more favourable than loan capital. Five factors contribute to that; three of them have already been dealt with. They are the minimization of the separation and information costs of the shareholder as well as the minimization of costs involved in the operation of securities markets. Because limited liability reduces the separation and the information costs of the shareholder and because it enables him to eliminate his risk by disposing of his share rapidly and cheaply, he is expected to ask for an *ex ante* compensation - in the form of a reduction in the share price - lower than the one he would ask under unlimited liability.

In addition, limited liability has two secondary consequences, namely diversification of holdings and providing a market for corporate control, which reduce further the shareholder's risk of not receiving any dividend at all. As a result, the shareholder asks from the company a lower reduction in the share price and the company's cost of raising capital is further reduced.

1. Diversification of holdings

Because limited liability enables shareholders to abstain from being involved in the company's management, they are strongly encouraged to divide the amount which they have available for investment among more than one company. They have a certain interest to do so, since by holding shares in more than one company they can diminish the risk of loss of the whole amount invested. It is safer for an investor to divide ten pounds and to put one pound in ten different companies than to put the whole of the ten pounds in one company. In the former case, if one of the ten companies goes into insolvency, the investor loses one pound; in the latter case, however, the full amount of his investment, i.e. the ten pounds, is at risk³⁵.

If, on the contrary, shareholders are subject to unlimited liability, they are discouraged from diversifying their holdings among more companies, since the insolvency of any of them could result in the loss of their entire wealth. Thus, "the rational strategy under unlimited liability

35. F.H. EASTERBROOK & D.R. FISCHER, *op. cit.*, pp. 96-97; J. HICKS, *op. cit.*, pp. 16-17; H. G. MANNE, *Our Two Corporation Systems: Law and Economics*, 53 Va. L. Rev. 1967, p. 259 at 262.

would be to minimize the number of securities held. As a result, investors would be forced to bear risk that could have been avoided by diversification, and the cost to firms of raising capital would rise³⁶.

By virtue, therefore, of limited liability, shareholders are encouraged to diversify their holdings and, in effect, they become able to diminish their risk and to offer capital on more favourable terms for the company.

2. Market for corporate control

It has previously been mentioned³⁷ that, under limited liability, the price of the shares is determined by the performance and the prospects of the company³⁸ and not by the identity and wealth of the existing shareholders. A management departing from a policy of profit maximization will cause dissatisfaction among shareholders who see their dividends being reduced. Within an efficient securities market, shareholders will answer by offering to sell their shares, thus effecting a reduction in the share price. Outsiders, tempted by the reduction, may bid for a large bloc of shares in order to obtain control of the company and replace the existing managers.

This possibility exercises a constant pressure on managers to avoid a policy which is largely ignorant of the shareholders' interests. Managers whose seats on the board of a company are a source of income as well as a source of prestige, are, to a certain extent, forced to follow a policy that maximizes return for shareholders, i.e. a policy of regular dividend payments³⁹. Thereby, the shareholders' risk of not receiving a satisfactory return on their investment is significantly reduced and, accordingly, they are expected to demand a lower amount of *ex ante* compensation. In effect, the company's cost of raising equity capital is further reduced.

36. F.H. EASTERBROOK & D.R. FISCHER, *op. cit.*, p. 97. According to Blumberg, the argument that limited liability contributes to diversification of portfolio and, therefore, to decrease of the risk, "applies only to individual shareholders without substantial wealth. Persons of wealth, as well as financial institutions are in a position to diversify, notwithstanding shareholder liability. Since financial institutions hold about half of all shares on the New York Stock Exchange, the significance of the encouragement of individual portfolio diversification is markedly weakened". PH.I. BLUMBERG, *op. cit.*, p. 69.

37. See above, c.

38. "The present value of the income stream generated by a firm's assets." F.H. EASTERBROOK & D.R. FISCHER, *op. cit.*, p. 95.

39. H.G. MANNE, *op. cit.*, pp. 265-266; J. HICKS, *op. cit.*, p. 19.

iii) Risk-shifting function

The application of limited liability is not advantageous for everybody having an interest in the operation of a company. By virtue of limited liability, the risk of the company's failure may have been removed from the shareholder but, by no means has it been eliminated; in fact, it has been shifted to the company's creditors⁴⁰. In the event of the company's failure, creditors whose claims have not been satisfied by the company, cannot, in principle, proceed against the personal property of shareholders.

Creditors of the company may well be financial institutions, commercial providers, trading individuals and firms, the company's employees, its customers or even members of the public claiming for damages.

To cope with the risk which is shifted to them, creditors can take protective measures. For instance, they can ask for an *ex ante* compensation, the amount of which shall reflect the degree of the risk that their claim against the company will not be satisfied⁴¹. Loan creditors, in particular, can ask for an interest rate which will compensate them not only for the use of the capital lent, but for the risk that their loan will not be repaid⁴². Trade creditors can agree with the company a price higher than the market price of their products or services; employees can demand a wage or salary high enough to indemnify them *ex ante* for the possibility of not receiving it; finally, consumers can demand a reduction in the market price of the company's product to cover the possibility of suffering damage for which they will not be compensated.

To determine the appropriate amount of the *ex ante* compensation, creditors need to assess the existing risk of not obtaining satisfaction and to monitor the activities of the company in order to avoid being subjected to risks for which they are not compensated⁴³.

40. "Limited liability does not eliminate the risk of business failure. Someone must bear that loss." F.H. EASTERBROOK & D.R. FISCHER, *op. cit.*, p. 98; "[L]imited liability is a means not of eliminating the risks of entrepreneurial failure but of shifting them from individual investors to the voluntary and involuntary creditors of the corporation - it is they who bear the risk of corporate default." R. POSNER, *Economic Analysis of Law*, *op. cit.*, p. 370.

41. "The compensation they [employees, consumers, trade creditors and lenders] demand will be a function of the risk they face. One risk is the possibility of nonpayment because of limited liability. Another is the prospect, common to all the debtor-creditor relations, that after the terms of the transaction are set the debtor will take increased risk, to the detriment of the lender." F.H. EASTERBROOK & D.R. FISCHER, *op. cit.*, pp. 104-105.

42. See the example given by R.A. POSNER, *The Rights of Creditors of Affiliated Corporations*, 43 U. Chi. L. Rev., 1976, p. 499 at 501, where it is illustrated that the interest rate on a loan is payment not only for renting capital but also for the risk that the borrower will fail to return it.

43. "Assessment of the risk of default requires accurate information about the existing and expected assets and liabilities of the borrowing corporation and of anyone else who may be liable for the corporation's debts, insofar as those assets and liabilities affect the creditor's ability to obtain repayment ... The second source of risk to the creditor is the possibility that the corporation will take steps to increase the riskiness of the loan after the terms have been set ... the creditor must supervise or regulate the corporation's

The exercise of this calculation and supervision requires not only substantial amount of resources but it, also, presupposes that the creditor has the practical ability to undertake it. A creditor who has no link with the company whatsoever, for instance, a tort creditor who is neither the company's employee nor a consumer of its products, is, for practical reasons, unable to take any protective measure. Likewise, a creditor who is somehow related to the company but who does not avail himself of the necessary bargaining power or the necessary skills, is not in a position to impose on the company terms which protect him effectively.

Therefore, the burden of bearing the risk of non-satisfaction is not identical for the different categories of creditors. It varies according to circumstances having to do with the kind of the relationship between the particular creditor and the company, the awareness and foreseeability of the risk, the bargaining power of the creditor to negotiate in advance compensation for it, and the need for speed and flexibility in modern transactions.

a. Financial creditors

It was mentioned earlier that equity investment is not the only way through which a company can be financed⁴⁴. For a number of reasons, a company may prefer to seek capital from institutions and individuals in the form of a commercial loan or an investment loan⁴⁵. The former is provided by commercial finance providers and the latter is provided by investors, who, instead of becoming shareholders of the company, prefer the fixed return of a debt instrument, i.e. a debenture⁴⁶.

Financial creditors have the legitimate expectation of seeing their loan being repaid on redemption date and yielding the fixed rate of interest on payment dates. In the event of the company's failure, however, they do not have recourse to the shareholders' personal assets unless there is a guarantee to this effect. It seems, therefore, that the interposition of the rule of limited liability shifts the risk of business failure from the owners of the business to its financial creditors.

disposition of its assets to the extent necessary to prevent any deliberate attempts to reduce the assets available to repay the loan." R.A. POSNER, *The Rights of Creditors of Affiliated Corporations*, op. cit., p. 508.

44. See above, ii, d.

45. For an explanation why firms have loan capital in addition to their equity capital, see R.A. POSNER, *Economic Analysis of Law*, op. cit., pp. 373-379.

46. For a comprehensive view on loan capital, see J.H. FARRAR, N FUREY, B. HANNIGAN, op. cit., ch. 19, pp. 252 et seq.

Normally, however, loan capital is provided and handled by powerful financial institutions who are perfectly aware of the risks that a particular loan entails. They are manned by experienced and skilled personnel who can embark upon a detailed consideration of the company's actual financial situation and of its prospects for the future. Their bargaining power enable them not only to refuse to provide the loan but, alternatively, to ask for a rate of interest that corresponds to the risk assumed, for a personal guarantee from a substantial shareholder or a director of the company, or for security such as a floating charge; they can also insist on contractual terms which prevent the company from undertaking extremely risky operations after the execution of the contract⁴⁷.

Hence, although limited liability appears to shift the risk of business failure towards financial creditors, the majority of them or at least the powerful, sophisticated and experienced ones, are in a position to protect themselves. Moreover, they can shift the risk back to the shareholders by insisting on personal guarantees as a precondition for providing the loan.

b. Trade creditors

As an economic agent, the company assumes the liability to pay in exchange for goods or services supplied by other companies or individuals. Insofar as the company is not paying instantaneously in cash, sellers of goods such as its suppliers of raw materials as well as suppliers of services such as the decorators of its premises can be considered creditors of the company. In this case, the credit allowed to the company takes the form of instalments or postponement of payment.

Like any other creditor, trade creditors can look for satisfaction only to the assets of the corporation and not to the personal assets of shareholders. Therefore, they bear the risk that the insolvency of the company may leave them unsatisfied.

One could argue that, like the financial creditor, the trade creditor can take protective measures in order to minimize his exposure to the risks of insolvency. Since his relationship with the company is a contractual one, the trade creditor has the opportunity of assessing the risk of non-satisfaction before entering into the contract and negotiating for terms which best protect him. If it seems that the company is facing serious financial difficulties, a reasonable trade creditor should either withdraw from the transaction or ask for a guarantee or increase the price of the

47. See R.A. POSNER, *Economic Analysis of Law*, op. cit., p. 371.

goods sold or reserve for himself the contractual right to prevent the company from embarking upon risky activities which may expose him to greater risks.

However, this may only rarely happen. Trade creditors, in most cases, lack the skills and the expert knowledge which is required for a detailed consideration of the risks involved in a particular transaction with a company. In addition, they do not have a strong incentive to spend considerable time and resources for exhaustive negotiations with a company since, normally, they do not extend huge amounts of credit. As it is felicitously pointed out, trade creditors "are simply not in business to bargain for credit"⁴⁸. It would be unrealistic to expect a trade creditor such as a seller of furniture to assess the credibility of all the companies with which he transacts and to contract around even the remotest possibility of his non-satisfaction.

Especially when the goods or the services are provided to a great number of customers, trade creditors do not normally negotiate terms with every one of them separately. Instead, they make use of standard form contracts⁴⁹. A set of uniform terms applies to all the contracts for the supply of particular goods or services in order to save on transaction costs. The widespread use of standard form contracts indicates that trade creditors rarely embark upon an investigation of the creditworthiness of a particular company⁵⁰.

Some protection is afforded to trade creditors by the inclusion of retention of title clauses in their contracts with the company. By virtue of a retention of title clause, goods are supplied to the company subject to a reservation of title to the seller pending payment of the price. Although in Continental Europe as well as in the USA such clauses are widely used, the English courts came to consider them for the first time as late as in 1975⁵¹. Thereafter, such clauses became known as "Romalpa clauses". However, the protection afforded by retention of title clauses to trade creditors is neither comprehensive nor always effective. They can operate only in favour of sellers of goods and not in favour of suppliers of services. Besides, their validity

48. For this reason, Blumberg regards them as involuntary creditors. See PH.I. BLUMBERG, *op. cit.*, p. 78. On the contrary, Easterbrook and Fischel regard them voluntary creditors able to demand compensation for the risk that they face. See F.H. EASTERBROOK & D.R. FISCHER, *op. cit.*, p. 104. See also, R.A. POSNER, *The Rights of Creditors of Affiliated Corporations*, *op. cit.*, p. 505.

49. For standard form contracts, see R. GOODE, *Commercial Law*, 1982, repr. 1986, pp. 39-40, 96-97; N. SAVAGE, R. BRADGATE, *Business Law*, 1987, pp. 187-188.

50. "...it is common for suppliers of goods and services to have standardized prices of goods and credit terms. The widespread quotation of prices such as "2%/10 days, cash/30 days" reflects a uniform pricing system that saves transaction costs by reducing the need for individual decision making and supervision." J. M. LANDERS, *Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy*, 43 *Univ. of Chi. L. Rev.*, 1976, p. 527 at 530.

51. *Aluminium Industrie Vaassen BV v. Romalpa Aluminium Ltd.*, [1976] 2 All E.R. 552; [1976] 1 W.L.R. 676.

is not always upheld⁵² and the courts do not hesitate to treat them like charges with the effect that their non registration renders them valueless as against a Receiver or a liquidator⁵³.

It can be concluded, therefore, that trade creditors are not always in a position to protect themselves from the effects of limited liability. The risk of the company's failure is shifted to them and it is rather unlikely that they will be able to take measures to eliminate it or to ask compensation for incurring it. As far as they are concerned, the limited liability of the shareholders is a potential source of uncompensated risks.

c. Employees

The employees of the company have the claim for payment of their wages and salaries. Where the company cannot satisfy their claims, employees, in principle, cannot reach the personal assets of the shareholders because of the rule of limited liability.

There will always be a contractual relationship between the company and its employee in the form of an employment agreement. However, it is not reasonable to expect an employee, while negotiating the terms of the agreement, to take into account credit considerations about the company. The typical employee has neither the access to crucial information concerning the company's credibility nor the economic strength to impose terms which secure the satisfaction of his claim.

Exceptionally, there are cases where employees of a company are large firms which provide staff specialized in a particular field such as accountancy, legal services or corporate finance. For instance, a major accounting or law firm may be employed by a manufacturing company. Such firms, due to their sophistication and bargaining power, are able to have access to superior information about the affairs of a company as well as to impose terms which protect effectively their interests. Similarly, a top corporate executive such as an experienced managing or finance director, can effectively protect himself since he has the ability to assess the financial standing of the company and the risk of its insolvency⁵⁴.

52. For a comprehensive view on retention of title clauses, see N. SAVAGE, R. BRADGATE, *op. cit.*, pp. 325-328 and I. DAVIES, *The Trade Debtor and the Quest for Security*, paper presented in W.G. Hart Legal Workshop on Insolvency, IALS 1991.

53. For a recent comprehensive statement of this position, see Compaq Computer Ltd. v. Abercorn Group Ltd., [1991] B.C.C. 484.

54. See P. HALPERN, M. TREBILCOCK, ST. TURNBULL, *op. cit.*, pp. 149-150.

However, professional employees and top corporate executives constitute only an insignificant minority compared with the bulk of clerks, servants, workmen and labourers that may be employed by a company. The difficulty of the latter to secure the payment of their remuneration is recognized by the majority of the legal systems which contain provisions for the employees' protection. For instance, under the UK Insolvency Act⁵⁵ and the US bankruptcy laws⁵⁶ employees are considered preferential creditors and, as a consequence, in the winding up of the company, their claims are satisfied before the claims of most other creditors.

Nonetheless, the relevant provisions give priority only to employees' claims up to a certain amount⁵⁷ and they protect employees only to the extent that the company can meet, at least, its obligations towards preferential creditors. Where the company's assets are insufficient to satisfy even the preferential creditors, the provisions in question offer no protection.

A more effective means of protection is provided for by the current New York statute, which imposes joint and several liability on the ten largest shareholders for all salaries and wages of the company's employees⁵⁸. The statute, which applies only to New York corporations, provides that the action can be brought against the shareholders only after a judgement has been obtained against the company and returned unsatisfied.

In general, however, employees of a company do not receive such a favourable treatment. For Macharzina, "by limiting liability it is now the worker, and not the shareholder, who is personally liable for the consequences of corporate decisions"⁵⁹. Although this statement may seem to be exaggerated, it is not far from reality. Employees, with few exceptions, have no effective means of protection against the risks which limited liability shifts to them.

55. IA 1986, ss. 175 and 386 and Sch. 6.

56. 11 U.S.C. par.507(a)(3) (1982).

57. Currently, in the UK, the pre-insolvency salary of the four months before the relevant date (for the relevant date, see IA 1986, S.387), up to a certain limit prescribed by order made by the Secretary of State; in the US, pre-insolvency six months wages up to \$2000.

58. N. Y. Business Corporation Law, par. 630; see also the Wisconsin statute (Wis. Stat. Ann. par. 180.40(6)) imposing liability for wages on shareholders.

59. K. MACHARZINA, *Corporate Forms and Limited Liability in German Company Law*, in T. ORHNIAL (ed.), *op. cit.*, p. 44 at 67.

d. Tort creditors

Tort creditors are those persons who have claims for damages against the company. Damages may be caused either by a defect of the company's product or by an accidental event related to the company's course of business. In principle, if the company cannot meet the claim for damages by its own means, the tort creditor remains unsatisfied because of the limited liability rule.

1. Consumers

Consumers can be either wholesale purchasers or retail consumers. Normally, the relationship between a wholesale purchaser and the company will be a contractual one. Wholesale purchasers are often large firms themselves and the transactions between them and the company involve large amounts. They are expected, therefore, to negotiate terms providing for the defective execution of the company's contractual duties. Insofar as such terms are finally inserted in the agreement between the company and a wholesale purchaser, the latter can safeguard his interests.

On the contrary, the nature of transactions between the company and a retail consumer is of a kind that does not require negotiating and contracting expenses. At the most, it will be an implicit agreement of buying and selling. In deciding which product to buy, the typical retail consumer is unlikely to take into account credit considerations about the manufacturing company.

The typical retail consumer is a person who, in principle, lacks the skills of an experienced transacting party. In addition, the value of the transaction is often so insignificant that the consumer does not have a strong reason to investigate the company's credibility and to negotiate and contract around the remote possibility of suffering damage as a result of the consumption of the company's products⁶⁰.

In recognition to the difficulties faced by consumers in protecting themselves, the EEC Directive on product liability abrogates any kind of limitation of liability in cases where a consumer falls

60. See PH.I. BLUMBERG, *op. cit.*, p. 78.

victim to an injury caused by a company's product⁶¹. However, the shareholders of the manufacturing company still retain their limited liability.

2. Victims of an accident

Tort creditors may also be employees of the company who suffer injuries while working for which the company is held responsible. Notwithstanding that there will probably be provisions for workmen's compensation in the employment agreement, negotiation and detailed contracting over the remote possibility of an unsatisfied claim for damages may be an unreasonably expensive exercise⁶².

Tort victims claiming for damages may also be members of the public who suffered injuries caused by an accidental event which was somehow related to the company's activities (e.g. a company car accident or an explosion in the company's premises). Accidents of this nature may possibly have disastrous effects for a multitude of persons. It is not unlikely that the company will be unable to face all its liabilities. In this case, the limited liability rule precludes tort creditors from having access to the personal property of shareholders.

Whereas the consumer of the company's product and its employee is somehow voluntarily engaged into a relationship with the company, the above tort creditor had no previous dealings with the company whatsoever. He did not have the opportunity of protecting himself since he was not engaged in any kind of relationship with the company⁶³. If he is not insured against the effects of the accident, and the company becomes insolvent, he will not receive any compensation.

61. OJ 1985 L 210/29.

Article 1. The producer shall be liable for damage caused by a defect in his product.

Article 12. The liability of a producer arising from this Directive may not, in relation to the injured person, be limited or excluded by a provision limiting his liability or exempting him from liability.

62. "The slight probability that an employee will be seriously injured in the job, when multiplied by the probability that the employer will have insufficient assets to satisfy his claim for workmen's compensation, may be too small to warrant inclusion of an express term in the employment contract to cover that contingency." R.A. POSNER, *The Rights of Creditors of Affiliated Corporations*, op. cit., p. 506.

63. The example given by Posner is quite representative: "A pedestrian is struck by a moving van in circumstances making the moving company liable to him for a tort. Pre-existing negotiations, explicit or implicit, between the parties with respect to the moving company's ability to make good on the pedestrian's claim are simply not feasible". R.A. POSNER, *The Rights of Creditors of Affiliated Corporations*, op. cit., p. 506.

3. The solution of insurance

For consumers and employees who are voluntarily engaged into some sort of relationship with the company, a solution would be to insure themselves against the risk of the particular tort and, thereby, to shift the risk of the company's failure to the insurer. However, even if this sort of insurance was available, it would be extremely unreasonable to expect that large masses of consumers and employees of the company would purchase it⁶⁴.

For members of the public, however, the solution of insurance is not even feasible. Insurance presupposes that the victim was aware of the risk and could foresee the inability of the company to meet the arising claims. But accidental events are of a fortuitous nature and may occur in various ways. It cannot be expected from a person totally unaware of the risks that a company's activity entails, to foresee the disaster and bear the cost of insurance against it.

The mere probability that the company, itself, may be insured against a great variety of potential tort events does not satisfactorily protect potential tort victims, unless the company is obliged to be insured, as in the case of car accidents⁶⁵.

Hence, tort creditors, as a whole, are severely affected by the application of limited liability. As it is said, "tort liability is a cost of the enterprise that limited liability transforms into an externality (that is, a cost of the enterprise borne by persons not associated with it)"⁶⁶.

B: CONCLUSION

Since limited liability does not constitute an attribute of the separate legal personality of the company but a rule which is applied in order to serve mainly economic purposes, its real value lies on its economic functions. Three are the main economic functions of limited liability:

1. Stimulating investment;
2. Minimizing cost; and
3. Shifting risk.

64. See PH.I. BLUMBERG, *op. cit.*, p. 79.

65. For the issue of insurance, see P. HALPERN, M. TREBILCOCK, ST. TURNBULL, *op. cit.* pp. 138-145; R.E. MEINERS, J.S. MOFSKY and R.D. TOLLISON, *op. cit.*, pp. 364-367; F.H. EASTERBROOK and D.R. FISCHER, *op. cit.*, pp. 101-103, 107-109.

66. PH.I. BLUMBERG, *op. cit.*, p. 75.

Stimulating investment can be considered as the primary economic function of limited liability. People are encouraged to invest because their maximum loss is confined to the amount of their investment.

The cost-minimizing function of limited liability manifests itself in four different ways:

1. Limited liability reduces the costs involved in the separation between management and ownership. Thus, it makes it possible for a multitude of investors to contribute to the company's capital without having to supervise the way in which the company is run.
2. Limited liability reduces the information costs that a shareholder has to incur in order to be constantly aware of the real value of his investment.
3. Limited liability reduces the costs involved in the operation of securities markets. Consequently, transactions in the shares of a company can be realized efficiently.
4. Limited liability reduces the company's cost of raising capital; it enables a company to be financed on the most favourable terms. This is achieved not only by virtue of the interaction of the previous three factors, but also, by virtue of diminishing the shareholder's risk of receiving a low or no dividend through diversification and through the efficient operation of the market for corporate control.

Finally, limited liability removes the risk of the company's failure from shareholders and shifts it to creditors. Those of the creditors who have deliberately extended credit to the company and, additionally, those that are sufficiently skilled, experienced and powerful can protect themselves. They can shift the costs of bearing the risk back to shareholders either in the form of higher prices and rates of return or in the form of personal guarantees by shareholders or managers. On the contrary, those of the creditors who have not the opportunity, the experience, the skills or the bargaining power to ask for effective protection have to bear the risk without being compensated.

The significance of limited liability in each particular case depends on the interaction of its economic functions. For the overall economic effect of limited liability to be advantageous, the social benefit from stimulating investment and minimizing costs should outweigh the costs which are placed on creditors. If this does not happen, limited liability is not an optimal legal rule and it serves no real purpose.

CHAPTER III: THE TYPICAL GROUP OF COMPANIES

Before proceeding to the assessment of the significance of limited liability for groups of companies, it is necessary to attempt a description of the group of companies. The economic functions of limited liability within the context of a group can be properly assessed only when the specific features of the group are detected and analyzed.

A: THE EMERGENCE OF GROUPS OF COMPANIES

In general, groups of companies emerge as an alternative way of expansion of a corporation. Originally, they emerged by virtue of the recognition of the power of a corporation to own shares in another. It is significant, however, that at the time when limited liability was established, groups of companies were virtually unknown.

In the United States, in the early years of limited liability, i.e. between 1830-1865, authorizations for ownership of shares of other corporations were very reluctantly granted and only to companies of a public character, such as railroad companies. In the absence of an express provision in the statute or the charter, it was held *ultra vires* or unlawful for a corporation to acquire shares in another corporation¹. It was only during the first quarter of the twentieth century, i.e. half century after the acceptance of limited liability, that this power was universally recognized².

In the U.K., a company was able to purchase shares in another company only by virtue of a provision to this effect in the memorandum of association of the purchasing company. In a

1. PH.I. BLUMBERG, *The Law of Corporate Groups: Tort, Contract and other Common Law Problems in the Substantive Law of Parent and Subsidiary Corporations*, 1987, pp. 56-60.

2. See H. BALLANTINE, *Corporations*, rev. ed. 1946, p. 39. This power is now codified in s. 3.02(6) of the revised Model Business Corporation Act of 1984, which has been adopted in numerous states; see R.W. HAMILTON, *The Law of Corporations*, 3rd ed., 1991, pp. 7-8.

number of cases following the enactment of the 1862 Companies Act, the English courts held that an acquisition of shares was *ultra vires* when the memorandum was silent³. When, however, the memorandum provided so, it was held that a company could acquire shares in another⁴.

Nowadays, groups of companies are formed more often as the result of a merger or a takeover or as a result of deliberately splitting a company into different parts carried on by separate organizational and legal units⁵.

When a group is formed as a consequence of a merger, a new company is usually formed in order to acquire the shares of the merging companies from their existing holders in exchange for shares of the newly formed company. Thus, the merging companies become the operating subsidiaries of the new company whereas the latter does not carry on any business activity itself but it becomes a holding company, i.e. it merely operates as a link between its shareholders and the subsidiaries.

A group is formed as a consequence of a takeover when a company bids for the shares of another company and the offer is accepted by the holders of all or a majority of the shares of the target company. The acquiring company may elect to continue carrying on its original activity or cease its activities and become a holding company.

Finally, a group is formed when an already large company decides to split its undertaking into different parts carrying on different functions of the same business or different businesses or operating in different territories or a combination of all these.

Irrespective of the way in which a group has been formed, the different subsidiaries may carry on businesses which are not commercially related to each other; the group is then known as a conglomerate group. Where the different subsidiaries supplement or support the main activity of the group, for instance, when one subsidiary manufactures the product, another one distributes it and another finances the whole operation, the group is known as a vertical group. Where, finally, the different subsidiaries operate at the same level of the same business, for instance when all the subsidiaries manufacture or distribute the same product, the group constitutes a horizontal group.

3. *Re Asiatic Banking Corp.*, (1869) 4 L.R. 252, at 262; *Great Eastern Railway v. Turner*, (1872) 8 L.R. 149, at 151-152; *Re European Society Arbitration Accounts*, (1878) 8 Ch. App. 679.

4. *Re Barmen's Banking Co.*, (1867) 3 L.R. 105, at 112, 113; *Re Asiatic Banking Corp.*, *ibid.*, at 257.

5. R.R. PENNINGTON, *Pennington's Company Law*, 6th ed., 1990, pp. 729-730.

B: THE FEATURES OF THE TYPICAL GROUP

i) The profile of the typical group

In general, the group of companies may be defined as an association of companies which operate with a view to the profitability of the association as a whole. Within the group, the different companies surrender their individuality and become mere parts of a bigger organization. Modern firms are known with names such as Philips, Canon, General Motors and ICI; these names refer to multinational groups of companies whereas the names of the individual subsidiaries constituting these groups are virtually unknown.

Nonetheless, the subsidiaries constituting the group have all the external characteristics of the typical company: they have separate corporate personality, they keep separate accounts, they are taxed separately, they can sue and be sued separately and, more importantly, their parent companies are protected by the limited liability rule.

However, as will be shown below⁶, the majority of subsidiaries lack an essential attribute of the typical company: the independent management. As an integral part of a bigger organization, subsidiaries exist and operate for the benefit of the organization as a whole. The interests of the individual subsidiaries are bound to be subordinated to the interests of the parent company. The parent company, by virtue of its direct or indirect majority shareholding in its subsidiaries or by any other informal means, can secure compliance with its wishes.

Thus, the typical subsidiary is a company which is potentially managed contrary to its own interests as a separate concern. The service of interests other than its own ones, distinguishes the typical subsidiary from the typical independent company. A majority shareholder of a typical independent company directs its management towards the service of his personal interests which normally are the genuine interests of every investor: to see his company succeed as a viable concern and provide him with a good return on his investment. On the contrary, a parent company, in managing its subsidiary, does not pursue the genuine interests of an investor but it pursues its own interests as a distinct economic unit, often at the expense of the subsidiary's interests.

6. Below, ii, c.

ii) Description of the typical group

It is not appropriate to describe the typical group simply by reference to the legal relationship between its member-companies. Instead, it is necessary to understand the typical group's organizational framework and to analyze its distinguishing features. Because groups cannot be easily categorized according to their form of operation, it would be simplistic to divide them into conglomerates, vertical and horizontal groups and to attempt to find the particular characteristics of the different categories. It is more appropriate and useful to attempt an insight into the actual affairs and operations of some groups irrespective of the category in which most probably belong.

The observation of the internal organization and operation of the group which follows, is predominantly based on the results of a small survey which was undertaken for the purposes of the thesis⁷ while useful information was obtained from other empirical studies and from the recent annual accounts of some domestic and foreign companies belonging to a group. The survey is based on a number of interviews held and answers received by officials of companies belonging to groups. The main conclusions and the results of the survey are presented in this chapter while the full interviews and answers can be found in the appendix at the end of the thesis.

The requested information was provided by officials of the following companies:

1. I.C.I. Plc., the English overall parent company of the ICI group.
2. General Electric Co. Plc., the English overall parent company of the General Electric group.
3. Unilever Plc., an English company which is one of the two parent companies of the Unilever group.
4. Philips U.K. Ltd., an English subsidiary of Philips of Holland.
5. Shell U.K. Ltd, an English subsidiary ultimately owned 60% by the Royal Dutch Petroleum Co. and 40% by the English Shell Transport and Trading Co.
6. BMW (GB) Ltd., an English subsidiary of BMW AG of Germany. 7. Canon U.K. Ltd., an English subsidiary of Canon of Japan.
8. Mitsubishi Electric U.K. Ltd., an English subsidiary of the Mitsubishi Electric Corp. of Japan.
9. Ford Motor Co. Ltd., an English subsidiary of the American Ford Motor Co.
10. ITT Industries Ltd., an English subsidiary of the ITT Corp. of U.S.

⁷. See appendix.

11. The Japanese overall parent company of a group in the automobiles industry. It was requested that the information provided can be used only on the condition that the group's name will not be mentioned.
12. General Motors Corporation, the American overall parent company of the General Motors group.
13. Ciba-Geigy AG, the Swiss overall parent company of the Ciba-Geigy group.

On the whole, the survey proved highly useful for the purposes of the thesis, although it does not claim any statistical validity. The groups included in the survey cannot be considered as forming a representative sample, since they were chosen at random from the Times 1000, a yearly list of the 1000 largest industrial companies.

As the companies approached belong to groups of different nationalities and operate within different industries, one would expect that the answers of their officials would greatly vary. However, the answers received are quite similar and they prove that, although the groups adopt various forms of operation and organization, there are certain features which are present in almost every case: the complexity of their legal structure, the divergence between their legal structure and their managerial organization and the substantial degree of operational dependence of each subsidiary on the groups' headquarters, i.e. the overall parent company.

a. Complexity of legal structure

Theoretically, a group may consist of only one parent and one subsidiary company; in practice, however, many groups organize themselves into a large number of parent, subsidiaries and sub-subsidiary companies scattered throughout the world.

According to recent data presented by The Corporate Policy Group⁸, the top 50 UK companies head groups with over 10,000 subsidiaries with the average being 230 each and a range from 5 to 858⁹. Not all of these subsidiaries are directly held by the parent company but there is more than one level of ownership within most of the groups studied, ranging from one to eleven levels. On average, the parent has 52 subsidiaries at the first level, which itself has 77

8. For the Corporate Policy Group project, see R.I. TRICKER, *Corporate Governance: practices, procedures and powers in British companies and their boards of directors*, 1984, pp. 1, 54-57.

9. These numbers include operating subsidiaries and operating associates (companies in which another company holds less than 50% of its equity capital) and exclude dormant companies (non trading companies that the group elected not to wind up for various reasons).

subsidiaries at the second, which has 47 at the third, 28 at the fourth and 16 at the fifth¹⁰. Also, a study of 180 major American corporate groups by J. Curhan, W. Davidson and R. Suri, based on data from the Harvard Multinational Enterprise Project, reveals that these groups in 1975 had 11,198 foreign subsidiaries with an average of 60 each¹¹.

In particular, in the 1992 Reports and Accounts of the General Electric Company Plc. appear some 90 subsidiary companies; in the 1992 Corporate Profile of Mitsubishi Electric Corp'n. of Japan, appear 80 subsidiary companies and in the 1991 Annual Accounts of the BMW group 31; in the 1991 Annual Report of Ciba-Geigy appear 106 subsidiary companies and in the Annual Report of the same year of Johnson & Johnson, under the heading "Worldwide Family of Companies", 125 companies are listed.

The Unilever group has two parent companies which, according to their common Annual Accounts of 1991, "operate as nearly as is practicable as a single entity, have the same directors and are linked by agreements including an Equalisation Agreement which is designed so that the position of the shareholders of both companies is as nearly as possible the same as if they held shares in a single company"¹². Below these two international holding companies, there are subholding companies and below them trading companies but sometimes there are further levels, as well. The group as a whole has 180 principal subsidiaries defined as those which, "according to the opinion of the directors principally affect the amount of profit and assets shown in the Unilever Group Accounts"¹³; the shares of the subsidiaries are directly or indirectly held either by the Dutch or the English parent.

The Shell group has also two parent companies. But it differs from the Unilever group in that the shares of the subsidiaries are ultimately owned 60% by the Dutch parent and 40% by the English parent. There are subsidiaries operating in more than 100 countries which themselves have their own subsidiaries. The Shell U.K. Ltd., for instance, has approximately 170 subsidiaries¹⁴.

10. R.I. TRICKER, *op. cit.*, p. 56.

11. J. CURHAN, W. DAVIDSON, R. SURI, *Tracing the Multinationals* (1977), p. 143, cited in PH.I. BLUMBERG, *The Law of Corporate Groups*, *op. cit.*, p. 99; data from the study are represented in PH.I. BLUMBERG, *The Law of Corporate Groups: Procedural Problems in the Law of Parent and Subsidiary Corporations*, 1983, pp. 31-32 and appendix, pp. 464-472.

12. Unilever, *Annual Accounts and Additional Financial Information 1991*, English version, p. 2.

13. *Ibid.*, p. 20.

14. Appendix, V, *qus.* 1, 2.

It is significant that, in all the groups studied, the percentage of equity capital directly or indirectly held by the parent company is almost always 100%. In very few cases are there outside shareholders and this is almost invariably the case where it is considered important to have local participation or where a joint venture is operated¹⁵.

The proliferation of subsidiaries constitutes a continuous process since a large number of new subsidiaries are formed every year in different geographical areas¹⁶. There are various reasons for the complexity of the structure of the groups and the proliferation of their subsidiaries. One of the main reasons appears to be the fact that many groups expanded through the acquisition of already existing businesses with established organizational structures consisting of holding and subsidiary companies. In order to avoid the cumbersome procedure of changing existing structural arrangements, the group's headquarters sometimes prefer not to absorb the newly acquired companies into a more rational structure¹⁷.

Tax considerations also constitute an important reason for operating through a great number of subsidiaries. Most of the group officials emphasized the importance of tax issues when considering operating through a company or a branch in a particular territory. The officials of ICI and General Electric Co. Plc., did not hesitate to hold that the main reason for operating through complex structures is to take advantage of the different national taxation laws¹⁸.

Subsidiaries are also formed because of the symbolic function carried by the prestigious title of the director of a company. As the official of General Electric said, "you cannot have directors of divisions ... you can call them some thing or other but people who run businesses like to be called directors and there is a sort of a prestige involved in being a director"¹⁹.

Another reason for having a great number of subsidiaries was pointed out by the official of Canon U.K. Ltd. He emphasized that most of the operating subsidiaries of his group exist because, as he said, "we believe in small is beautiful, the concept of having a small operating

15. According to the study of the 180 major United States corporate groups (see *supra*, fn. 11), out of 11.198 subsidiaries 8.059 were found to be wholly owned.

16. See P. BUCKLEY & M. CASSON, *The Future of the Multinational Enterprise*, 2nd ed., 1991, pp. 3-7.

17. "These factors are not always strong enough to prevent the implementation of a thoroughgoing rationalisation of group structures, with the elimination and eventual liquidation of large numbers of subsidiaries ... But they are often sufficient to ensure that numerous subsidiaries survive within large British groups as apparently independent companies, at least until lack of profitability or some other circumstance draws the attention of senior management to their anomalous position." T. HADDEN, *Control of Corporate Groups*, IALS, 1981, IALS, p. 10.

18. Appendix I, qu. 2 and II, qu. 2, respectively.

19. Appendix II, qu. 2.

unit with the means to measure its complete activity. Most of our subsidiaries are bits of our organization made into a separate company so that we can more easily measure the performance and reward the management"²⁰.

It thus appears that the creation and the maintenance of large numbers of subsidiaries in the organizational structure of groups serves various purposes. It is a mixture of tax, accounting and management considerations which lead groups to operate through such complex structures. If, in addition, account is taken of the considerable number of non trading companies, the so-called dormant companies²¹, it may be concluded that subsidiaries are formed and maintained for reasons which have nothing to do with the reasons for which an independent company is created.

An independent company is normally created as a capital-raising device and as a device for risk-taking. But an 100% subsidiary is a totally different case. It exists solely for the purpose of serving the various interests of the group as a whole. It is significant that from the 13 group officials contacted, only two stated that subsidiaries proliferate because of different and separate activities.

b. Divergence between legal structure and managerial organization

A striking feature of the operation of many groups is the divergence between legal structure and managerial organization. Whereas the separation into different legal units is important for legal and external accounting purposes, for managerial purposes this separation is almost meaningless. It is significant that the officials of almost all the groups emphasized that a subsidiary company may well be a distinct legal unit but it will rarely be an important managerial unit.

It is worth citing the words of the official of Unilever:

"You'll find that 99% of the people in the company have no appreciation of the legal structure. They are not interested in the legal structure. All management, all internal accounting, all internal financing is largely independent of the legal structure. We think of Unilever as one entity. It is only the lawyers, the tax people, the company secretaries that have to remember the formal shape."²²

20. Appendix, VII, qu. 2.

21. These are companies which groups elect not to wind up for various reasons. As the official of ICI said "you never know when you may need them in the future ... They might often be a useful vehicle to carry out a particular transaction, they might have a name or a licence that you want to use ... Equally it is often more trouble to wind up companies"; appendix, I, qu. 3.

22. Appendix, III, qu. 4.

Likewise, the official of ICI said that, in actual fact, the legal structure is "almost a legal fiction in terms of how we actually manage our businesses and operate the group"²³.

It is, also, significant that of the four groups studied by Hadden in 1981²⁴, not even one adopted a managerial structure that corresponded absolutely to the group's legal division into parent and subsidiary companies. Similarly, in the research undertaken by Tricker, "the individual studies provided ample confirmation" of the fact that "the organization structure adopted for running the business, taking management decisions and exercising management control, does not reflect the corporate structure of the member subsidiaries"²⁵.

Hence, the legal organization of a group normally says nothing about the way in which its operations are managed. In management terms, the crucial separation is that into different divisions. The group as a whole is normally divided into distinct operational units, each of them charged with a specific function or with all the functions related to a specific product.

The groups studied do not seem to adopt a uniform approach in their segmentation into divisions. Groups such as BMW, Unilever, Mitsubishi Electric, Canon and Philips are mainly divisionalized on a product basis with the subsidiaries in the different territories having sometimes the function to support the divisions locally. The BMW group is divided into the Automobile Business, the Motorcycle Business, the Aeronautical Engineering Business and the Electronics Business. The Unilever group has four main divisions: the Food Products Division, the Detergents Division, the Speciality Chemicals Division and the Personal Products Division. The Mitsubishi Electric group is divided into the Automotive Equipment Group, the Consumer Products Group, the Information and Communication Systems Group, the Electronic Product and Systems Group, the Electronic Devices Group and a group charged with the co-ordination of international operations²⁶.

The Shell U.K. group follows a combination of product and functional divisionalization. There are four essential divisions: the exploration and production division, the oil manufacturing supply and marketing division, the chemicals and the metals division²⁷. As ICI currently

23. Appendix, I, qu. 4.

24. Bowater Corporation, Rank Organization, Reckitt and Colman Ltd and IBM (U.K.) Holdings Ltd., in T. HADDEN, *op. cit.*, p. 10 and appendices.

25. R.I. TRICKER, *op. cit.*, p. 62.

26. This information is taken from the Annual Accounts of the companies concerned.

27. See the Annual Accounts of Shell U.K. Ltd; also, see appendix, V, qu. 7.

stands, there are 8 international major businesses. They are in practical terms operated on a worldwide scale²⁸.

In the GEC group where the coincidence between legal structure and managerial organization was particularly stressed, it was pointed out that divisions have to be within a single subsidiary. "By definition, a division is an unincorporated part of a company and if you are talking about different companies you have to have different divisions", said the official of GEC²⁹.

But a product division may, as well, consist of several subsidiaries throughout the world. As a group official answered to Tricker, "companies can be grouped together for management purposes on an apparently random basis, for example, one which is based on product groups, and these can have no legal connection with the way the shares are held"³⁰.

In the 1991 Annual Report of BMW, for instance, 21 companies located in several countries appear to belong to the Automobiles and Motorcycles Division; in the 1991 Report of Unilever 45 subsidiaries appear to belong to the Foods division and there are 27 subsidiaries, operating mainly outside Europe and North America, different parts of which belong to different divisions.

What makes the divisionalization of the group very important for management purposes is the fact that the managing and the internal accounting system within the group normally follows the lines of its divisional structure. The legal structure remains relevant only for external accounting and taxation purposes. But as the director of Unilever said, the only real relevance of external accounting procedures "is for reporting our performance to the shareholders, investors and analysts"³¹.

For example, the different divisions of the Mitsubishi Electric group are required to report back to the heads of the divisions in Japan³². As the official of Philips pointed out, the managing director of the consumer division of Philips U.K. Ltd. reports directly to the board of the consumer division in Holland which overlooks and manages the part of the division in the

28. Appendix, I, qu. 4.

29. Appendix, II, qu. 4.

30. R.I. TRICKER, *op. cit.*, p. 64.

31. Appendix, III, qu. 4.

32. Appendix, VIII, qu. 4.

U.K.³³. The 8 international major businesses of the ICI group are in practical terms operated on a worldwide scale. The official of ICI emphasized that "in management terms the board of ICI France does not determine the policy of our company in France. It is the headquarters of the particular business wherever that is located"³⁴.

In the Canon group, the marketing managers of the different product divisions have to account to the persons responsible for the particular product in the overall parent company in Japan. Although the product divisions do not have to report directly to Tokyo, they have to achieve targets set for them by Tokyo. "Each product division in Tokyo has expectations for what will happen in the U.K." said the official of Canon U.K. Ltd. "So, the head of the copier division in Tokyo will expect the U.K. to sell x number of copiers. It will put a lot of pressure onto the marketing manager in the U.K. to sell that number of copiers."³⁵

From the 1991 Report of Johnson & Johnson³⁶, where the term Company refers to the whole group, the following extract is quite relevant:

"The Executive Committee of Johnson & Johnson is the principal management group responsible for the operations of the Company. In addition, three Executive Committee members are Chairmen of Sector Operating Committees, which comprise managers who represent key operations within each Sector, as well as management expertise in other specialized functions. These Committees oversee and coordinate the activities of domestic and international companies related to each of the consumer, pharmaceutical, professional and diagnostics businesses. Operating management of each company is headed by a President, General Manager or Managing Director who reports directly or through a Company Group Chairman."

T. Hadden found that, in the Bowater Corporation, each operating company was required to make monthly reports on its performance to its divisional centre and the divisional centre was then required to make similar reports to the responsible executive director on the main board, in the parent company³⁷; in the Rank Organization, the managing director of each of the

33. Appendix, IV, qu. 2.

34. Appendix, I, qu. 4.

35. Appendix, VII, qu. 5.

36. P. 67.

37. T. HADDEN, *op. cit.*, p. 54.

operating subsidiaries reported, with few exceptions, to his divisional director, and the divisional director reported to the Group Managing Director, in the parent company³⁸.

Finally, in the extensive litigation concerning the major accident in Bhopal, it was evidenced that the Union Carbide of India Ltd., which was part of a geographic division of the Union Carbide group, was required to report to Union Carbide Eastern Inc., a wholly-owned Union Carbide subsidiary, which in turn had to report to the parent company. Product divisions of the Indian subsidiary had to report to their respective product line managers of the ultimate parent³⁹.

There exists, therefore, a general pattern of divisionalizing the business of the group as a whole irrespective of the legal units in which the group is formally separated. The divisions are the managerial units of the group and they often comprise a number of subsidiaries located in different countries. As the official of Shell U.K. stated, the object of this kind of managerial organization is to operate as a single company⁴⁰.

c. Graduation of dominance by the parent company

1. Legal control v. managerial control

By virtue of its majority shareholding in the subsidiary, a parent company always has the power to exercise control over its subsidiary. Holding the majority of the votes in the general meeting of the subsidiary either directly or indirectly, a parent company can decide on major issues for the subsidiary and can appoint or dismiss the majority of the members of the subsidiary's board.

This form of legal control is the control expected to be exercised by any majority shareholder. A majority shareholder is always in a position to exercise control on the affairs of the company by using his statutory rights. The exercise of his control, however, presupposes that the company is a distinct economic unit with its own interests and its own objectives. Its general meeting and its board of directors are duly convened and decisions are taken on the basis of the best interests of the company.

38. T. HADDEN, *op. cit.*, p. 63.

39. P. MUCHLINSKI, *The Bhopal Case: Controlling Ultrahazardous Industrial Activities Undertaken by Foreign Investors*, 50 M.L.R. (1987), p. 545 at 571.

40. Appendix, V, qus. 3, 4.

However, within the group structure as it was presented above, the control exercised by the parent company over its subsidiary goes much further. It is not a mere exercise of legal rights; the parent company does not confine itself to the role of the typical majority shareholder but, to a certain extent, it becomes the actual manager of the subsidiary. Because of the centralized managerial organization of the group, the subsidiary has little space for real autonomous decision-making and major issues for the subsidiary are essentially decided at the level of the parent.

As a matter of fact, the extent of the managerial involvement of the parent depends on various factors. Groups engaged in advanced industrial operations, for instance in automobile and computer production, are expected to follow a highly centralized policy with all the major decisions decided by the parent⁴¹.

On the contrary, non wholly-owned subsidiaries and joint ventures are expected to enjoy a considerable degree of autonomy. Care is normally taken to ensure that the interests of the non wholly-owned subsidiaries are not subordinated to the interests of the group as a whole and that minorities are not unfairly treated⁴². On the other hand, joint ventures in which a group takes part, are operated wholly independently from the other operations of the groups involved⁴³.

Apart from these exceptional cases, it is reasonable to assume that the different subsidiaries of the group are typically operated with a common view to the benefit of the group as a whole and the parent company substantially intervenes in their management.

41. "Renault makes various components in Rumania, Spain, Argentina, which are all assembled in the same car in a number of plants around the world. This means that decisions about how much is to be made and when, where, and at what price it is to be shipped must be made in the central headquarters. It also means that each country where Renault has a components factory is dependent upon decisions of the Paris headquarters and has little leverage of its own." R. BARNET & R. MULLER, *Global Reach*, 1975, p. 42.

42. A former Company Secretary of Unilever Plc. pointed out that in the non wholly-owned subsidiaries of the group, the policy is "to give the closest possible attention to the interests of the outside shareholders both in compliance with the applicable legislation and in compliance with the spirit and practice of fair dealing". J. KEIR Q.C., *Legal Problems in the Management of a Group of Companies*, in C. SCHMITTHOFF & F. WOOLDRIDGE (ed.), *Groups of Companies*, 1991, p. 46 at 51.

43. "Such a company [a joint venture] represents a form of co-operation with another enterprise. It is not under the sole direction of the head office of the multinational group. Its management is a matter of agreement between two or more enterprises who have joined forces in the company established by them. A company of this type enjoys genuine independence. Its interests are not identical with those of either of its constituent members." C. SCHMITTHOFF, *Group Liability of Multinationals*, in K. SIMMONDS (ed.), 1977, *Legal Problems of Multinational Corporations*, p. 71 at 71-72.

2. The case-studies

Group executives usually stress the autonomy enjoyed by operating subsidiaries⁴⁴. For taxation purposes, care is always taken to ensure that the subsidiary appears to be duly operating and conducting its business independently of the parent company. As the official of ICI stated, "you have to be careful that since you have a subsidiary for a particular reason, it is necessary that is seen to be making its decisions and to have properly constituted board meetings and that everything is kept in order"⁴⁵.

Nevertheless, the officials of most of the groups contacted did not hesitate to admit that their subsidiaries are actually managed by the parent company of the group. However, the extent and the form of managerial intervention by the parent company does actually vary in the different groups concerned. It takes various forms and ranges from establishing a "coherent and well understood commercial policy and within that policy to give wide flexibility of action to individual management and boards"⁴⁶ to rendering the subsidiary "a mere tool of operation for the parent company", as the official of Ford UK Ltd. pointed out⁴⁷.

The general philosophy of the Canon group, as the official of Canon U.K. Ltd. described it, is "very loose control". The subsidiary companies do not receive policy plans or policy manuals but only a very general policy statement setting the percentage of the production that each subsidiary is expected to sell. In case that this percentage is not sold, the subsidiary has to account to the parent. The parent also sets a limit to the amount of capital expenditure; subsidiaries cannot spend more than a certain amount without getting approval from the parent. But apart from that, the parent company has nothing to do with the financial policy or the personnel policy of the subsidiary and there is very little interference on a day-to-day basis⁴⁸.

In the ITT group, the parent intervenes in the management of the subsidiaries only on a general basis. This intervention can cover general guidelines and policies, but not usually trade related policies or management. Except for corporate strategy or group tax planning reasons, the parental board of directors rarely takes decisions concerning the subsidiary companies. In the areas of finance, production, marketing, R & D, capital expenditure and operating budgets, the

44. See T. HADDEN, *op. cit.*, p. 14; R.I. TRICKER, *op. cit.*, p. 58.

45. Appendix, I, qu. 4.

46. J. KEIR Q.C., *op. cit.*, p. 50.

47. Appendix, IX, qu. 4.

48. Appendix, VII, qu. 7.

subsidiary management is substantially autonomous but global constraints are set by the parent for each area⁴⁹.

In the BMW group, guidelines are issued by the parent company according to which the general policy of all the group companies is formulated. The budgets of the subsidiaries as well as major capital expenditures have to be approved by the parent company. The subsidiaries have a mandate to try to produce the profit they budgeted for and they are expected to take actions to achieve that. Within these limits, the managers of the subsidiary have the authority to run the day-to-day operations of the subsidiary. There is very loose centralized control on personnel policy. As far as marketing policy is concerned, it was the policy of the group to have a central marketing policy but it was soon realized that it is very difficult to have a uniform marketing policy all over the places⁵⁰.

In the GEC group, the parent company instructs the subsidiary's management by virtue of a circulus which goes out from the head office in the parent company to the managing directors of the individual units. Written instructions and guidelines are also issued, for instance in relation to financial matters, by the financial director of the parent company.

Budget meetings are convened in the group's headquarters in London, before the beginning of the financial year. Each subsidiary presents its plans for the forthcoming financial year and if those plans are considered unsatisfactory, they are rejected. Provided that a particular capital expenditure is within the budget originally approved, it does not need a further approval by the parent unless it is above a certain amount. Similarly, if a subsidiary wants to enter into a contract involving an amount which is above a certain limit or it contains unusual conditions or if a subsidiary wants to hire a person at a salary above a certain level, it has to get approval by the parent company⁵¹.

In the Ford group, the general policy of the subsidiaries as well as specific policy issues are determined by the parent. For this purpose, policy letters, policy plans and a lot of general guidelines are issued by the parent. The financial, the personnel and the marketing policy of the Ford subsidiaries are extremely similar to the respective policies of the parent, even when they are not strictly determined by it. There is a co-ordination company, called Ford Europe

49. Appendix, X, qus. 3, 4.

50. Appendix, VI, qu. 4.

51. Appendix, II, qus. 7, 8, 9.

which operates as a service company with employees from other national Ford companies, with the purpose of co-ordinating and recommending their long-term policy⁵².

In the Mitsubishi Electric group, the Japanese parent company has a liaison office in London with a number of managers whose task is to collect information from Europe and to return it to Japan. They are almost all Japanese, they form different management groups and they hold regular meetings with senior managers of the subsidiaries in order to obtain the necessary information. Since everything is conducted in the Japanese language, it is difficult, as the official of Mitsubishi Electric Corp. admitted, to assess how closely the parent monitors subsidiary matters. In any event, a monthly report is sent to the parent and proposals to create a new factory or major changes in strategy should be reviewed and approved by the parent⁵³.

It is also significant that the management of the English subsidiary does not place great emphasis on board meetings as such. There are only two official meetings of all the directors every year. They are convened only as a method of communicating on a regular basis where everyone meets and can exchange information and not as a method of development of policy⁵⁴.

In the Unilever group, the management boards of the subsidiaries have only a narrow scope of decision-making authority. The general policies and the financial targets of the subsidiaries are set by the divisional heads. The interviewed official of the parent company said the following:

"More and more as our businesses are more clearly transnational, more and more we are setting guidelines on personnel matters, marketing policies, trademark policies ... There is a trend towards more setting from the centre than it used to be. But within the terms of the general policy, the company chairmen will tend to have a quite wide discretion".⁵⁵

Likewise, the subsidiaries of the Philips group are managed on a worldwide, global basis. Within certain product guidelines and financial restrictions which are all set by the parent company, the managers of the subsidiaries are only responsible for the day-to-day management of their company. Even the decisions concerning major marketing and senior personnel issues have to be approved by the divisional centres in the parent company⁵⁶.

52. Appendix, IX, qu. 5.

53. Appendix, VIII, qu. 6.

54. Ibid., qu. 18.

55. Appendix, III, qu. 5.

56. Appendix, IV, qus. 3, 4, 5, 6.

In the ICI group, as was mentioned earlier, the 8 businesses constitute the principal management units of the group and they are operated on a worldwide scale; subsidiaries have very little, if any, managerial autonomy. The official of ICI described as follows the degree of authority delegated to subsidiary companies:

"There is the board of the parent on the top which delegates to the heads of the eight major businesses the authority to run their own businesses within certain limits: they can spend up to a certain amount of money, they can buy and sell businesses up to a certain amount of money. Above that they have to refer back to the board. The heads of those businesses delegate certain amount of authority down to other people but no subsidiary company will do anything unless it knew it was within the policy of that relevant business of the group as a whole."⁵⁷

In the Ciba-Geigy group, the parent is in control of financial matters for the whole group⁵⁸; in the General Motors group most actions by the subsidiaries require written consent by the parent except for actions of major subsidiaries⁵⁹. Finally, in a Japanese group in the automobile industry, although subsidiaries have some autonomy with respect to day to day decisions regarding sales and marketing strategy, they follow the overall business strategy and budgetary instructions set by the parent company⁶⁰.

It may, therefore, be concluded that, typically, the parent company establishes the policy of the group as a whole and the main goals to be achieved. Guidelines are issued within which subsidiary executives are obliged to run a particular subsidiary and the policy of all the units of the group is coordinated in respect of all the major aspects of their operations. Budgets and all the major issues for the subsidiary are essentially decided by the parent company by virtue of the requirement for parental approval. The subsidiary's management actually retains effective decision-making authority only for routine day-to-day matters.

57. Appendix, I, qu. 8.

58. Appendix, XIII, qu. 3.

59. Appendix, XII, qu. 4.

60. Appendix, XI, qu. 3.

C: CONCLUSION

Groups of companies emerge in a variety of ways and adopt various forms of operations. However, some organizational and operational features may be considered as characterizing the typical group since they are found to be present in the overwhelming majority of the groups.

First of all, the typical group of companies constitutes an economic unit which is divided into a great number of legal units, for purposes of convenience of any kind.

Secondly, a simpler functional group structure is superimposed on the complex legal structure of the group. Within the simplified functional group structure, the real important segmentation of the group is into managerial units, namely into divisions; the segmentation into legal units, namely into subsidiaries, retains its relevance only for external accounting, taxation and limitation of liability purposes.

As managerial authority is removed from subsidiaries and is transferred to divisions, the ultimate decision-making centre of the group is the board of the parent company where the heads of the divisions sit or are obliged to report.

In practical terms, the decision-making authority of the parent goes beyond any genuine form of legal shareholder control. The degree of managerial involvement by the parent usually extends to the point of actually managing the subsidiaries of the group as if they were mere departments of the group's overall operations. Even in those groups where a great deal of autonomy is allegedly afforded to subsidiary companies, this mainly constitutes a choice of policy by the group's headquarters; the parent always retains the residual ability to intervene in order to "to get things done" according to its own wishes. In any event, as the chairman of Ronson's British subsidiary stated "the manager of the subsidiary must accept that he enjoys a subordinate status, and that a subsidiary company is an organ of the parent company, and that policy is basically formulated and handed down by the parent company"⁶¹.

61. R. BARNET & R. MULLER, *op. cit.*, p. 42.

CHAPTER IV: THE SIGNIFICANCE OF LIMITED LIABILITY FOR GROUPS OF COMPANIES

The significance of limited liability for the single, independent company rests on its function as an incentive to investment as well as on its cost-minimizing and risk-shifting functions¹. Notwithstanding that limited liability may operate contrary to the interests of some categories of creditors, its overall effect appears to be positive; on aggregate, limited liability, appears to be a rule which contributes to economic progress. Although, this is only a theoretical assertion and lacks any sort of empirical support; such support, would be provided, for instance, if it could be evidenced that the number of incorporations under unlimited liability is significantly smaller than the number of incorporations under limited liability. The only existing empirical data is provided by the English experience: between 1844-1856, when unlimited liability was the rule, 956 companies were registered, whereas between 1856-1865, when limited liability became the rule, some 5,420 companies were registered².

However, when limited liability protects the corporate assets of the parent company within the typical group, as it was described in the previous chapter, the balance of effects of its functions turns out to be socially disadvantageous. Specifically, the limited liability of the parent for the debts of its subsidiary does neither stimulate a great deal of investment nor it minimizes the costs involved in the operation of the subsidiary; moreover, the risks shifted to the creditors of the subsidiary are greater than the risks shifted to the creditors of a single, independent company.

1. See *supra*, ch. II.

2. H.A. SHANNON, *The first five thousand Limited Companies*, Econ. Hist., 1932, p. 396 at 420-421. See also R. MEINERS, J. MOFSKY and R. TOLLISON, *Piercing the Veil of Limited Liability*, 4 Del. J. Corp. L. 1979, p. 351 at 362, where they discuss the Massachusetts experience before and after 1829 when charters of incorporation started providing for limited liability. They conclude that the change in the liability rule had no effect on the number of incorporations; this conclusion, however, is of limited importance since it refers to a period when incorporation still required a petition for a charter.

A: THE ECONOMIC FUNCTIONS OF LIMITED LIABILITY IN THE PARENT - SUBSIDIARY CONTEXT

i) Limited liability as an incentive to investment

It might be expected that limited liability encourages groups of companies to invest in socially worthwhile schemes and to undertake business risks which might not be undertaken in the absence of limited liability. It is actually argued that without limited liability "some worthwhile but risky ventures which might be undertaken by groups would not be undertaken at all"³.

This would be the case if groups were generally undertaking new ventures and were regularly expanding into new markets. Quite often, however, almost all the subsidiaries of a group are engaged in the same activity or in activities such as marketing or finance which are undertaken exclusively in order to support the main group activity. It is significant that out of the groups studied only Unilever, ICI and ITT are engaged and expanded in diversified areas of activity; even in these groups, however, expansion normally takes place through the creation of a new division and not of a subsidiary. Only the official of ITT mentioned among the reasons for creating a subsidiary the undertaking of a separate trading activity⁴.

Limited liability, though, retains its significance as an incentive to invest in cases where a group decides to expand geographically through the creation of new subsidiaries. Direct investment of this kind in developing countries assists the local economies by creating job opportunities for thousands of people. Moreover, when local participation is imposed by the national laws of the host country, the investment of the group is accompanied by local investment, either by the state or by individuals, and thereby the level of the local economic development is significantly raised.

When, however, major groups of companies with significant bargaining power manage to create new subsidiaries without local personnel and local participation, expansion in new geographical areas serves exclusively the interests of the group and may be detrimental to the general interests of the public. By creating such subsidiaries instead of operating through local branches, the group manages to segment its liability for the same worldwide activity into as many parts as the number of countries in which it actually operates. Additionally, it takes advantage of the different national taxation laws and thereby minimizes its overall tax liability.

3. T. HADDEN, *Inside Corporate Groups*, 12 *Int'l J. Soc. L.*, 1984, p. 271 at 281.

4. Appendix, X, qu. 1.

It seems, therefore, that limited liability really encourages investment and worthwhile risk-taking by groups only in the few cases where the creation of the subsidiary is the outcome of a genuine decision to invest in a new business or geographic area.

ii) Cost-minimizing function

a. Separation costs

In the context of the typical independent company, limited liability results in the reduction of the costs of separation between shareholders and managers. In the typical group, however, where the parent company is both the shareholder and the actual manager of its subsidiaries, there are no separation costs to be reduced.

As the evidence showed in the previous chapter, the parent company is almost invariably engaged in the actual management of its subsidiaries. The board of the parent company establishes the general policy of the group and the main goals to be achieved by each individual subsidiary. All the major issues for the subsidiary are essentially decided at the board of the parent. Even when considerable autonomy is afforded to the subsidiary's managers in respect to the day-to-day routine issues, the managers are obliged to act within the limits set by the policy manuals and the guidelines which are issued by the parent company.

Hence, the parent company, represented by its board, exercises both the functions of ownership and management. As the absolute owner of the subsidiary, the parent company through its board, theoretically performs the function of the subsidiary's general meeting; in fact, it also performs the function of the subsidiary's managerial board, since so many of the decisions concerning the subsidiary are taken by the parent. In effect, there is no real separation between owners and managers of the subsidiary and "the need to establish congruence of the interests of the manager and the owner-investor, with its attendant presumed agency and monitoring costs, simply does not arise"⁵.

b. Information costs

In the context of the independent company, the application of limited liability results in the reduction of the costs which present and future investors incur in order to obtain information about the wealth levels of the existing shareholders. However, within a typical group consisting

5. PH.I. BLUMBERG, *The Law of Corporate Groups: Tort, Contract and other Common Law Problems in the Substantive Law of Parent and Subsidiary Corporations*, 1987, p. 95.

of wholly-owned subsidiaries, information costs of this kind do not arise at all or they arise on a much lower scale.

Because the overwhelming majority of subsidiaries are wholly-owned by their parent⁶, investors who might consider becoming shareholders of a subsidiary and might need information about the other shareholders, do not exist. It is only with respect to non wholly-owned subsidiaries that limited liability reduces the information costs of the investor.

c. Securities Markets

Under limited liability, the personal wealth of every individual shareholder does not determine the value of his investment in the company. As a result, the shares of a company have identical prices regardless to whom they belong and transactions in them involve few costs; in effect, the efficiency of the securities markets is largely promoted.

In a typical group of companies consisting of wholly-owned subsidiaries, all the subsidiaries' shares are concentrated in the hands of the ultimate parent or intermediate parent companies. In these circumstances, there is no market for the subsidiaries' shares. Only when the subsidiary is not a wholly-owned one, can minority shareholders freely trade in its shares, unless there are restrictions on transferability.

But even in the rare case of a non wholly-owned subsidiary, trading in the subsidiary's shares is very likely to be depressed; the fact that there is a parent company holding at least 51% of the shares of the subsidiary and closely controlling it, may be a serious deterrent for outside investors. A prudent investor will normally avoid ending up in a minority position with no power to influence the management of the company.

Thus, the proposition that limited liability promotes the marketability of a single company's securities by reducing the costs involved in the operation of the securities markets is not equally valid in the context of a group and especially in the context of a group consisting of wholly-owned subsidiaries⁷.

6. See *supra*, ch. III, B, ii, a.

7. However, it is suggested that "limited liability will still have a beneficial impact on stock sale transaction costs in the context of wholly owned subsidiaries; it will e.g. greatly ease the separation of liabilities as between a parent intending to sell its subsidiary and the subsidiary itself". K. HOFSTETTER, *Parent Responsibility for Subsidiary Corporations: Evaluating European Trends*, 39 I.C.L.Q. 1990, p. 576 at 577, fn. 10.

d. The company's cost of capital

By virtue of the application of limited liability, the typical independent company can raise equity capital on the most favourable terms. The different functions of limited liability, namely, the reduction of the separation and the information costs, the reduction of the costs involved in the operation of the securities markets, the efficient operation of the market for corporate control and the diversification of shareholdings, are the factors which contribute to the reduction of the company's cost of capital.

In the typical group of companies, however, reduction of the subsidiary's cost of capital does not occur; not only because there are no separation or information costs involved or because there tends to be no market in the shares of the subsidiary, but because the subsidiary is not expected to raise any sort of capital from the capital markets. Generally, subsidiaries do not resort to the capital markets in order to raise capital on terms which reflect their performance as a going concern but, almost invariably, they are financed internally. All their working capital is provided either by the parent in the form of 100% subscription in the initial equity capital as well as in subsequent capital increases or by the parent and the finance company of the group -if there is one- in the form of intercompany loans.

By definition, the equity capital of wholly-owned subsidiaries is exclusively provided by the parent company. With respect to the provision of loan capital, it is significant that out of the thirteen officials contacted, only the officials of the U.K. subsidiaries of BMW and Canon pointed out that they do not rely on the internal resources of the group⁸. In the rest of groups, subsidiaries do heavily rely on financing by the parent or by the group finance company; it is only for small overdraft facilities or due to particularities of local markets that subsidiaries will borrow from an external source⁹.

Although some group officials stressed that dividends and rates of interests are always agreed on an arm's length commercial basis, the official of General Electric group did not hesitate to point out that loans to subsidiaries are regarded and treated by the parent as equity, however they may be described¹⁰; also, the official of Shell U.K. Ltd. admitted that subsidiaries "might get a mildly favourable treatment"¹¹. In this respect, highly relevant is the conclusion of

8. Appendix, VI, qu. 7 and VII, qu. 12, respectively.

9. For the reliance of subsidiaries on financing by the parent, see T. HADDEN, *Control of Corporate Groups*, 1981, IALS, pp. 15-16.

10. Appendix, II, qu. 14.

11. Appendix, V, qu. 9.

Hadden who, after studying the accounts of parents and subsidiaries of four major U.K groups, pointed out that, in some instances, "internal lending appeared to amount to the provision of capital by holding companies for the operation of their subsidiaries on a more or less permanent basis"¹².

It, thus, appears that the return which the subsidiary has to pay to its parent for the capital provided is not always a function of the risk faced by the parent, as would be the case if capital was provided to the subsidiary by an external investor. The subsidiary's cost of raising capital is not, therefore, determined by the usual open market factors but by the consideration of what is to the best interests of the group as a whole. The limited liability of the parent has no bearing at all on the amount of dividend or interest that the parent will ask from its subsidiary. Therefore, limited liability has no impact at all on the subsidiary's cost of capital.

iii) Risk-shifting function

In the course of its activities, a subsidiary, like any other company, may assume a wide range of obligations: obligations to repay capital borrowed from a financial institution as well as the interest thereon, to pay in exchange for goods and services bought, to pay wages and salaries to its employees and to pay compensation either to consumers for damages caused by its products or to the victims of an accident related to its activities. Thus, financial and trade creditors as well as employees and tort creditors, compose a wide interest group who have the legitimate expectation to see their claims being satisfied.

By definition, the application of limited liability in the parent-subsidiary context, limits the financial exposure of the parent towards the creditors of its subsidiaries. Even where the parent company is the absolute owner of the subsidiaries and it actually controls them, it has no liability for their debts beyond the amount of its investment in the subsidiary's capital. Thereby, the risk of the subsidiaries' failure is shifted towards their creditors.

There is a customary tendency either of parent companies to guarantee, formally or informally, that they will meet their subsidiaries' obligations or of all the companies of the group to guarantee each other's obligations through cross guarantees. Creditors can also secure the satisfaction of their claims by the usual means of personal guarantees, retention of title clauses and insurance. They can also ask for *ex ante* compensation for the risk of loss that they bear

12. T. HADDEN, *op. cit.*, p. 15.

or they can reserve for themselves the right to monitor the riskiness of the subsidiary's operations.

However, creditors of the subsidiary are not always in a position to protect themselves effectively against the risks which the limited liability of the parent shifts to them. Like creditors of an independent company, creditors of a subsidiary are only sometimes protected, depending on the kind of their relationship with the company, the particular risk which they have to face, their ability to foresee it and their bargaining power to demand *ex ante* compensation. Only the creditors who are practically able to protect themselves, and, additionally, have sufficient resources, skills, experience and sophistication can be effectively protected; for the rest of them, limited liability transfers uncompensated risks.

In fact, however, creditors of a subsidiary are in a more difficult position than creditors of an independent company. They have to face not only the usual risks faced by a creditor of an independent company but, also, a number of additional difficulties arising out of the typical group structure and practices.

As the group's decision-making authority with respect to financial matters rests invariably with the parent company¹³, the funds of a subsidiary may easily be transferred to the parent company which will then apply them for the purposes of the group as a whole. Thus, a subsidiary which one moment looks adequately capitalized and quite credible, may be deprived of its funds to the detriment of its creditors.

Also, the distinction between parent and subsidiary companies is not always clearly visible in business terms¹⁴. Almost invariably, the name of the group appears in the documents of the subsidiary in a way that gives the impression that the transaction is ultimately entered into by the parent company; in addition, in the overwhelming majority of cases, the subsidiary companies of a group carry a name similar to that of their parent, and use an identical

13. See *supra*, ch. III, B, ii, c.

14. "Suppose for example that a bank holding company establishes a subsidiary to invest in real estate. The holding company gives the subsidiary a name confusingly similar to that of the holding company's banking subsidiary, and the real estate corporation leases office space in the bank so that its offices appear to be bank offices. Unsophisticated creditors extend generous terms to the real estate subsidiary on the reasonable belief that they are dealing with the bank itself ... To protect the legal separateness of affiliated corporations in this case would lead creditors as a class to invest a socially excessive amount of resources in determining the true corporate status of the entity to which they were asked to extend credit." R.A. POSNER, *The Rights of Creditors of Affiliated Corporations*, 43 U. Chi. L. R. 1976, p. 499 at 521.

trademark for their products¹⁵. In these circumstances, the "unsophisticated general creditor"¹⁶ may form the impression that he is dealing with one integrated corporation responsible for all its obligations. But even a sophisticated one may fall victim on the trust he placed on the reputation of the group, as a whole.

Especially for tort creditors, an additional risk arises from the possibility that the group may undertake through a subsidiary an operation which is potentially profitable but potentially dangerous, as well. The rule of limited liability enables the group to enjoy all the profits in the event of success but to avoid liability in the event of an accident¹⁷.

a. Financial creditors

The course of action of financial creditors will greatly depend on whether the credit advanced to the subsidiary constitutes a short, a medium or a long term facility¹⁸. Short term loans usually take the form of overdraft facilities, loans with maturity of not more than one year, repayment obligations arising out of letters of credit or guarantees issued by the bank at the subsidiary's request and advances made by a bank accepting, purchasing or discounting bills of exchange or promissory notes issued by the subsidiary.

As these transactions between a bank and a subsidiary are of a routine nature and the amounts as well as the length of maturity involved are often insignificant, it is unlikely that a bank will undertake a costly assessment of the financial standing of the subsidiary and it will bargain accordingly the terms of the credit. In these circumstances, the most convenient means of protection is a letter of comfort issued by the parent company; although, letters of comfort may also be issued for medium and long term loans, if the parent company is, for a number of reasons, reluctant to guarantee formally the debts of its subsidiaries¹⁹.

15. From the consolidated accounts of all the groups studied, it is evident that the overwhelming majority of the companies belonging to the same group carry names confusingly similar to each other. Moreover, all group officials pointed out that companies belonging to the same group have the obligation to use the same trademark for their products, and special permission is needed for the use of a different trademark; see appendix.

16. As he is called by C.S. KRENDL & J.R. KRENDL, *Piercing the Corporate Veil: Focusing the Enquiry*, 55 *Denver Law Journal* 1978, p. 1 at 33.

17. For a list of the particular dangers faced by creditors of a subsidiary, see J. M. LANDERS, *Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy*, 43 *Univ. of Chi. L. Rev.* 1976, p. 527 at 527-528.

18. For a general view on bank finance for groups of companies, see R. R. PENNINGTON, *Bank Finance for Companies*, 1987, ch. iv, pp. 71 et seq.

19. See I. BROWN, *The Letter of Comfort: Placebo or Promise?*, J. B. L., 1990, p. 281. The study of Hadden revealed that, in the few cases that involved loss-making subsidiaries, auditors required the parent company to furnish a letter of comfort containing an express undertaking that the parent company will enable the subsidiary to meet all its liabilities. T. HADDEN, *op. cit.*, pp. 56, 66.

Letters of comfort commonly contain a statement by the parent company that its subsidiary will be in a position to meet its liabilities to the lender²⁰. In essence, the parent company assures the lender that it will stand behind the subsidiary if the subsidiary is not in a position to meet its liabilities by its own means.

However, the legal nature of the letter of comfort is controversial. Although it certainly creates a moral obligation for the parent, its legal effect is rather uncertain. There is a considerable divergence of opinions as to whether letters of comfort constitute binding contracts or not²¹. One commentator has suggested that, "under most jurisdictions the legal scope of such letters ranges from clearly non-committing language of a legally grey area to letters which come close or are identical to guarantees by the parent company for the respective subsidiary's financial standing and ability to meet all times its financial obligations"²².

Because of their doubtful legal effect, letters of comfort are not very popular among creditors who advance to the subsidiary medium and long term loans involving greater amounts and longer maturities. Instead, they normally ask from the parent company, and often from other subsidiaries with substantial assets in the same group, to enter into clear contractual commitments to support the subsidiary.

In particular, banks tend to ask for a guarantee by the parent company ensuring that the advances made to the subsidiary as well as interest, commission and administrative costs shall be duly paid. They may also ask for a form of security provided by the borrowing subsidiary and then supported by guarantees and securities by the parent and (or) other companies of the group. Thus, all the companies of the group become contractually bound to repay the loan advanced to one of them and all the group's assets can be called upon to meet one subsidiary's obligations²³.

However, according to the group officials of our small sample, parent companies are very reluctant to give formal guarantees. Notwithstanding that their policy is to support any subsidiary in financial difficulties, parent companies certainly prefer letters of comfort over

20. R.R. PENNINGTON, *op. cit.*, p. 78.

21. In *Kleinwort Benson Ltd. v. Malaysia Mining Corporation Berhad*, [1989] 1 W.L.R. 379, CA, it was held that a statement by a parent company that it is its policy to ensure that the subsidiary's business is at all times in a position to meet its liabilities, does not amount to a binding contractual undertaking but is merely a statement of policy. See I. BROWN, *op. cit.*; D.D. PRENTICE, 105 L.Q.R. 1989, p. 346.

22. KL. BÖHLHOFF, *INT'L BUS. L.*, 1978, Vol. 6(iii), p. 288.

23. For a detailed analysis of all the possible arrangements between the lending bank and the group, see R.R. PENNINGTON, *op. cit.*, pp. 78-79.

formal guarantees. "It is not the fear that the guarantee is more easily enforceable than a letter of comfort" the official of BMW said²⁴. Letters of comfort are preferred mainly because parent companies do not want a contingent liability to appear in their balance sheets.

Thus, whether a bank will succeed in obtaining formal guarantees and cross-guarantees greatly depends on its bargaining power. As the officials of ICI and Philips made particularly clear, parent companies will give formal guarantees only when they are pressed to do so by large institutions²⁵.

Even when a creditor of the subsidiary manages to obtain a guarantee by the parent company or to secure his claim through cross-guarantees, the validity of the transaction may be challenged on the ground that the guarantor company lacked capacity to enter it or on the ground that its directors abused their powers.

Before the implementation of art. 9 of the First Directive of the Council of the EC²⁶ by virtue of s. 9(1) of the European Communities Act 1972, if the guarantor's objects clause did not authorize it to guarantee or to secure the debts of another group company, the validity of the transaction could be challenged as being ultra vires²⁷. The scope of the ultra vires doctrine was substantially restricted by virtue of s. 35 of the Companies Act 1985, according to which the validity of a guarantee or security not authorized by the company's objects clause could be challenged only when the bank had not acted in good faith²⁸.

Section 108 of the Companies Act 1989 which replaced section 35 of the 1985 Act with three new provisions, ss. 35, 35A and 35B, virtually abolished the ultra vires doctrine and seems to have eliminated the possibility of challenging the validity of a guarantee for lack of capacity²⁹. Section 35(1) provides that "the validity of an act done by the company shall not be called into

24. Appendix, VI, qu. 8.

25. Appendix, I, qu. 15 and IV, qu. 8, respectively.

26. Council Directive (EEC) 68/151 (S edn 1968(I) p41).

27. Re Friary, Holyroyd and Healy's Breweries Ltd. [1922] W.N. 293.

28. In Barclays Bank Ltd. v. TOSG Trust Fund Ltd. [1984] BCLC 1, at 18, Nourse J. stated that "a person acts in good faith if he acts genuinely and honestly in the circumstances of the case".

29. It is suggested, however, that, for a number of reasons, the old s. 35 may still affect the validity of a transaction not authorized by the company's memorandum. See A.J. BOYLE & R.C. SYKES (ed.) *Gore - Browne on Companies*, 44th ed., 1986, vol. I, supp. 13, p. 3002.

question on the ground of lack of capacity by reason of anything in the company's memorandum"³⁰.

The guarantee or the security given by the parent or another group company to a creditor in favour of a subsidiary can be also challenged on the ground that it constitutes an abuse of the powers of the directors of the parent company. It is an established company law principle that the directors of a company should act *bona fide* in the interests of that particular company. In the case of Charterbridge Corporation Ltd. v. Lloyds Bank Ltd.³¹, for instance, it was held that:

"Each company in the group is a separate legal entity and the directors of a particular company are not entitled to sacrifice the interests of that particular company ... The proper test ... in the absence of actual separate consideration must be whether an intelligent and honest man in the position of a director of the company concerned, could, in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the company."³²

In that case, the guarantee and the security given to a bank by a subsidiary in favour of another company in the same group were held valid, because it was considered that the directors had incidentally acted in the interests of their own company.

On the contrary, in the case of Rolled Steel Products (Holdings) Ltd. v. British Steel Corporation³³, it was considered that a guarantee and a debenture executed by one company to secure the debts of another, constituted a breach of the director's duty to act in the interests of his company because the company obtained no benefit from them. They were held unenforceable by the creditor company because that company had actually knowledge of facts which showed that the giving of the guarantee and the debenture was an abuse of powers by the director. Although the case did not involve a parent and a subsidiary company in the strict

30. See also the similar U.S. Revised Model Business Corporation Act, s. 3.04(a), which has been virtually adopted by all states, and s. 3.02(7), which authorizes corporations to make guarantees.

31. [1970] Ch 62 at 74, [1969] 2 All ER 1185 at 1194.

32. See also the New Zealand Court of Appeal decision in Nicholson v. Permakraft, [1985] 1 N.Z.L.R. 242.

33. [1982] 3 All ER 1057.

sense, but two companies controlled by the same individual, it indicates the difficulties that a creditor may have to face in enforcing his guarantee against the parent company³⁴.

New section 35A of the Companies Act 1985 deals with the power of the directors to bind the company and provides that:

"In favour of a person dealing with a company in good faith, the power of the board of the directors to bind the company, or authorise others to do so, shall be deemed to be free of any limitations under the company's constitutions".

Therefore, the guarantee or security provided by the parent in favour of a subsidiary is voidable where the creditor knows that it was given exclusively for the interests of the subsidiary, unless the parent obtains a benefit from the transaction. However, when a parent company guarantees a loan made to its subsidiary, it will, almost always, obtain a benefit since the value of its investment in the subsidiary is improved or, at least, preserved³⁵. Also, a subsidiary may have an interest in guaranteeing a loan made to a fellow subsidiary when, for instance, the latter subsidiary markets the group's products or its failure threatens the credibility of the whole group³⁶.

Financial creditors will also have to be careful that their claims against the debtor, i.e. the subsidiary and against the guarantor, i.e. the parent company or a fellow subsidiary, rank prior to the claims of any other company of the group. This can be achieved by virtue of an agreement between the creditor and the other members of the group whereby the latter agree to subordinate their claims to those of the creditor³⁷.

The official of General Electric Company, for instance, pointed out the usual practice of auditors of denying signing the audit report of a subsidiary unless some form of subordination

34. Art. 437(3) of the French Law of July 27th 1966 provides that "the chairman, the directors or the general manager of the company, who, acting in bad faith, use the company's property or credit in a manner which they know to be contrary to the interests of the company, for personal ends or for the benefit of another company or enterprise in which they have a direct or indirect interest, shall be liable to imprisonment for one to five years, and to a fine of between 2,000 - 40,000 francs, or to either of those penalties". In German law, by virtue of the provisions of *Konzernrecht*, the group interest has been legalized and directors of a dependent company which is part of a control contract or an integration agreement can manage their company even contrary to its own interests. See below, ch. VIII, A, ii, a and b.

35. R.R. PENNINGTON, op. cit., p. 75. However, in *Lindgren v. L. & P. Estates Ltd.*, [1968] Ch. 572, it was held that the directors of a parent company are not compelled to take into account the interests of the subsidiary, although it was argued by counsel that the subsidiary is, in effect, property of the parent company.

36. D.D. PRENTICE, Group Indebtedness, in CL. SCHMITTHOFF & FR. WOOLDRIDGE (ed.), *Groups of Companies*, 1991, p. 55, at 60.

37. For subordination clauses, see R.R. PENNINGTON, op. cit., pp. 90-93; D.D. PRENTICE, op. cit., pp. 74-75.

letter is provided by the parent, whereby the parent agrees to subordinate the recovery of its claim against the subsidiary to the recovery of other creditors' claims³⁸.

The Bowater group employed a standard form of deed whereby debts owed by the subsidiary to the parent company were subordinated to debts owed to the other creditors of the subsidiary:

"The parent company hereby agrees that the sum of ... or such lesser amount as is for the time being owed by the subsidiary to the parent company (hereinafter referred to as the "subordinated indebtedness") is hereafter subordinated to other creditors of the company. The parent company shall be entitled at any time by deed to cancel this deed, but only if immediately after such cancellation the subsidiary would be solvent."³⁹

In its extreme form, a subordination clause will provide for the renunciation by all the companies of the group of any priorities for security, which they hold or may acquire over the assets of all other companies which are or may become members of the group⁴⁰.

Theoretically, therefore, financial creditors of subsidiaries and especially sophisticated and powerful financial institutions have a number of means of protection against the risk of a subsidiary's default. However, taking account of the difficulties of enforcing a letter of comfort or a guarantee against the parent company, it appears that financial creditors of a subsidiary are in a more difficult position than financial creditors of an independent company.

Financial creditors of an independent company know that they are dealing with one company which alone has to meet its obligation to repay the loan in the absence of any guarantee, personal or otherwise, and they take the appropriate measures. On the other hand, financial creditors of a subsidiary know that they are advancing credit to a company belonging to a group. Although they can cope with the particular risks involved by obtaining enforceable parental guarantees, cross guarantees and subordination clauses, they may, for practical reasons, refrain from doing so; they may, instead, enter into the loan agreement with the subsidiary, relying either on non-legally enforceable commitments or solely on the subsidiary's advertised link with a highly credible parent or on the good experience of their previous dealings with the group.

38. Appendix, II, qu. 16.

39. T. HADDEN, *op. cit.*, pp. 66-67.

40. R. R. PENNINGTON, *op. cit.*, p. 93.

Although group officials take care to stress their strong interest in standing behind the liabilities of every one of the group's subsidiaries irrespective of the security afforded to creditors, a dramatic change of the group policy may necessitate the abandonment of a particular subsidiary and the disregard of its financial creditors' interests.

b. Trade creditors

When the transaction between a subsidiary and a trade creditor involves a small amount of credit, the creditor does not have a strong interest to embark upon a detailed consideration of the credibility of the subsidiary as a separate concern. The fact that the subsidiary belongs to a well known group and has a number of well advertised links with a highly credible parent may sometimes be enough for the provision of the credit without any precaution.

When, however, the transaction involves a significant amount of credit, trade creditors are expected to ask for some protection. Like trade creditors of an independent company, trade creditors of a subsidiary may insert a retention of title clause either in the particular contract entered into with the subsidiary or in the standardized contractual forms that wholesale traders normally use⁴¹. As the officials of ITT and Mitsubishi Electric confirmed, trade creditors of subsidiaries quite often include retention of title clauses in their supply terms⁴².

However, trade creditors of a subsidiary may find it difficult to protect themselves by asking for guarantees, cross-guarantees and subordination clauses from the parent and other companies of the group. Due to time and cost considerations as well as due to the strictness of parent companies in providing formal guarantees⁴³, trade creditors may be forced to allow credit to a subsidiary relying on the credibility of the parent or, at the most, on a letter of comfort.

The official of Mitsubishi Electric U.K. pointed out that he could not "imagine the parent company needing to issue a guarantee on behalf of commercial business creditors in an ordinary commercial transaction" and that trade creditors are not normally in a position to insist even on letters of comfort⁴⁴.

41. See *supra*, ch. II, under ii, b.

42. Appendix, X, qu. 7 and VIII, qu. 12, respectively.

43. See *supra*, under a.

44. Appendix, VIII, qu. 17.

Normally, therefore, trade creditors bear the risk of the subsidiary's default, unless the parent decides, for policy reasons, to meet the subsidiary's obligations or a retention of title clause can be enforced.

c. Employees

Employees are considered preferential creditors by most legal systems⁴⁵. In English law this means that, if the available assets of the company are insufficient to meet the claims of general creditors, employees' claims will be paid in priority of all the debts of the company secured by a floating charge over its assets⁴⁶. In the context of a group, therefore, the employees of the subsidiary are satisfied before any claim of another group member secured by a floating charge over the subsidiary's assets.

Although preferential claims rank prior to claims secured by a floating charge, they are subordinated to claims secured by a fixed charge over a company's assets. Hence, if a parent company takes care to secure its claim against the subsidiary by a fixed charge, it will take priority over the preferential claims against the subsidiary. Additionally, the tendency of the courts to construe certain charges over the book debts of a company as being fixed and not floating charges renders the protection of preferential creditors even weaker⁴⁷.

Even in the absence of fixed charges, however, the protection afforded to employees of a subsidiary by the relevant provisions is not satisfactory. Even if there are tight links between the personnel of parent and subsidiary, and the parent, as usually happens, decides on major employment issues for the subsidiary, employees of the subsidiary cannot be considered employees of the parent for the purposes of the provisions concerning preferential claims. Because of the separate legal personality of the subsidiary and the rule of limited liability, employees of the subsidiary can look for the satisfaction of their claims only to the assets of the subsidiary.

45. See *supra*, ch. II, ii, c.

46. IA 1986, ss. 175, 386, Sch. 6.

47. These are clauses which entitle the creditor to the debts owed to the company soon after they come into existence and give him the right to collect them. See *Siebe Gorman & Co. Ltd. v Barclays Bank Ltd.* [1979] 2 Lloyd's Rep. 142 and *Re Keenan Brothers Limited* (Irish Supreme Court 1986) [1986] B.C.L.C. 242, where such clauses were construed as fixed charges. In *Re Brightlife Ltd.* [1987] Ch. 200; [1986] 3 All E.R. 673, the court regarded a slightly different clause as creating only a floating charge.

The EEC Directive on the safeguarding of employees' rights in the event of transfer of undertakings⁴⁸ is a significant step towards a more comprehensive protection of employees of a subsidiary, despite its restricted scope. This Directive applies to the transfer of an undertaking, business or part of a business to another employer as a result of a legal transfer or merger. Its main effect is the transfer of obligations arising out of an employment relationship from the transferor to the transferee.

The Directive may prove useful in the case where a subsidiary is closed down and its business is transferred to the parent. In this case, the parent company assumes the obligations of the subsidiary arising from its employment relationships existing on the date of the transfer. Thus, a group as a whole cannot avoid its obligations towards its employees by simply reorganizing itself.

However, it is not unlikely that a subsidiary will go into liquidation without having sufficient assets to meet the severance claims of its employees and without a transfer of its business to be effected. In the *Badger* case⁴⁹, for instance, an American company which was the head of the Raytheon multinational group, closed down a wholly-owned second-tier subsidiary located in Belgium. Initially the parent company refused to pay the debts of the subsidiary including the severance claims of the Belgian employees. Eventually it was forced to contribute towards the payment of the severance claims by the reaction of the trade unions at national and international level, the Belgian Government and the OECD. Notwithstanding the solution given, which may be attributed more to diplomatic pressures than to legal considerations, the *Badger* case constitutes a clear example of a decision by the group's headquarters to close down a subsidiary, leaving, among others, the employees unsatisfied.

A radical solution is provided for by French labour law⁵⁰. The French courts tend to attach liability to the parent for the severance or other claims of the subsidiary's employees, whenever the parent is involved in the relationship between the subsidiary and its employees. There is no requirement of proof of violation of duties by the parent or initiation of bankruptcy proceedings against the subsidiary. If, for instance, the parent decides on the number of

48. Council Directive (EEC) 77/187 (OJ L61 5.3.77 p26). For its implementation in English law, see J. McMULLEN, *Business Transfers and Employee Rights*, 2nd ed., 1992.

49. See R. BLANPAIN, *The OECD Guidelines for Multinational Enterprises and Labour Relations 1976-1979*, 1979, pp. 125-146; PH. I. BLUMBERG, *The Law of Corporate Groups, Problems in the Bankruptcy or Reorganization of Parent and Subsidiary Corporations*, 1985, pp. 635-640.

50. K. HOFSTETTER, *Parent Responsibility for Subsidiary Corporations: Evaluating European Trends*, 39 I.C.L.Q. 1990, p. 576 at 586; K. WEISSBERG & M.C. MOISSINAC, *Piercing the Corporate Veil in France*, 6 Int'l Fin. L. Rev., July 1987, p. 33 at 35.

employees to be hired or it customarily gives them direct instructions, it automatically assumes joint and several liability to the subsidiary's employees.

This solution is realistic because it takes into account the particular risks faced by persons employed in a company belonging to a group. All major decisions concerning employees of a subsidiary are essentially taken by the parent company. Group officials of our small sample stated that decisions concerning the appointment or dismissals of senior employees of a subsidiary, or a number of employees above a set limit or decisions concerning the closure of a particular subsidiary, are typically taken or, at least approved, by the parent company⁵¹. In these circumstances, it would be unreasonable to leave a subsidiary's employees unsatisfied considering that the parent company is a totally distinct economic entity.

d. Tort creditors

Tort creditors of a subsidiary may be consumers who have claims for damages caused by the subsidiary's product. If the parent company has participated in the manufacturing process of the product, liability may be imposed according to the provisions of the Consumer Protection Act 1987⁵² and the EEC Directive on product liability⁵³. These provisions impose strict liability on the manufacturer of a defective product; therefore, liability may be imposed on a parent company which participated in the manufacturing process of a product, irrespective of whether it was at fault or it did not sell the product to the ultimate user.

This development has been considered "as one of the most innovative of modern tort law"⁵⁴. However, it will not always be clear whether the parent has participated in the manufacturing process of the defective product. The product may have been designed, manufactured, distributed, sold or installed by the personnel of the subsidiary under the supervision of the staff of the parent. But even if the parent participated itself in the manufacturing process, such participation may not be always easy to prove.

In these circumstances, the purchaser of a product carrying a trademark indicative of the subsidiary's membership of a renowned group, may reasonably be misled into believing that he

51. See *supra*, ch. III, B, ii, c.

52. S. 2(2).

53. OJ 1985 L 210/29, art. 1. (see *supra*, ch. II, A, iii, d, 1). For a comprehensive view on the Directive and its implementation, see G. HOWELLS, *Comparative Product Liability*, 1993.

54. PH.I. BLUMBERG, *The Law of Corporate Groups: Tort, Contract and other Common Law Problems in the Substantive Law of Parent and Subsidiary Corporations*, 1987, p. 264.

bought the product from a large company such as Philips, Canon, Mitsubishi Electric. When, however, he asks for compensation for the damage incurred, he might be answered that the local subsidiary which is alleged to be the actual manufacturer of the product, has no sufficient funds to satisfy him.

Thus, even if the consumer bought the defective product from the subsidiary relying on the reputation of the parent whose name or trademark was indicated on the product, and even if the production was virtually carried out by the parent company, the parent may still avoid the imposition of strict liability and the consumer may be left uncompensated if the subsidiary becomes insolvent.

Tort creditors of a subsidiary may also be members of the public who fall victims of an accident related to the subsidiary's activities, such as a car accident or an explosion at its premises. It has previously been suggested that tort creditors of this kind are often inefficient bearers of limited liability risks⁵⁵. Since they do not have any sort of pre-existing relationship with the company, it is practically impossible for them to take any precautionary measure. Accordingly, to the extent that the company cannot meet all its obligations, tort creditors remain uncompensated.

Members of the general public who become tort creditors of the subsidiary, rely for their satisfaction on the capitalization of the subsidiary more than any other kind of creditor. Since they are most likely to have no opportunity of taking any other protective measure against the possibility of non-satisfaction, their only significant safeguard is the subsidiary's actual capitalization⁵⁶.

However, the typical financial group policy to finance subsidiaries through internal loans renders illusory the protection afforded to tort creditors. When the subsidiary's working capital is provided more in the form of loans than in the form of equity contribution by the parent, the paid up capital to which tort creditors can look for satisfaction, is relatively small and in some cases merely nominal.

Moreover, because companies belonging to a group are normally operated with a view to the profitability of the group as a whole and under a tight financial control from the group's

55. See *supra*, ch. II, ii, d.

56. F.H. EASTERBROOK & D.R. FISCHER, *The Economic Structure of Corporate Law*, 1991, p. 59.

headquarters⁵⁷, a company which initially looks adequately capitalized may be forced by the parent to transfer a significant part of its assets to another company or to the parent itself. Assets may be transferred not only by the means of internal lending, but, also, by the means of intra-group trading, declaring unjustified dividends, or paying excessive management fees⁵⁸.

Although intra-group transfers constitute a problem for all categories of creditors, tort creditors are more likely to be affected because, as it was previously said, the capitalization of the subsidiary is their only source of satisfaction. These practices expose the tort creditors of a subsidiary to unexpected and uncompensated risks since, apart, perhaps, from public pressure, there is nothing to prevent the parent company from leaving the victims of an accident unsatisfied.

But even when a subsidiary is adequately capitalized and the volume of intra-group transfers is insignificant, the extent of its tort liabilities may be such that the settling of the claims arising is impossible. In this case, it cannot be assumed that tort creditors are protected by virtue of personal injury and life self-insurance. A more realistic solution would be to expect subsidiaries engaged in high-risk activities to be insured up to the highest estimated amount of their potential liabilities. If the subsidiary company is unable to bear the costs of such insurance cover, the issue arises whether the insurance of the parent or, in the absence of such insurance, the parent itself, should be called on to pay the injury claims against the subsidiary⁵⁹.

The well known accident in Bhopal is a perfect example of the possible extent of the tort liability of a subsidiary. In that accident, because of gas leakage from the premises of a subsidiary of Union Carbide Corporation, about 2000 people are thought to have died with over 200.000 injured⁶⁰. The claims against the subsidiary reached hundreds of millions of dollars. The subsidiary, in these circumstances, was not able to meet the claims with its resources. The issue of the parent's responsibility for the obligations of the subsidiary has, in this case, arisen,

57. See *supra*, ch. III, B, ii, c.

58. See T. HADDEN, *op. cit.*, pp. 15-18; Posner disagrees and points out that, when parent and subsidiary operate in closely related businesses, "the common owner has a strong incentive to avoid intercorporate transfers that, by distorting the profitability of each corporation, make it more difficult for the common owner to evaluate their performance". R.A. POSNER, *op. cit.*, p. 514.

59. For the issue of insurance against ultrahazardous industrial activity as it arose in the Bhopal accident, see P.T. MUCHLINSKI, *The Bhopal Case: Controlling Ultrahazardous Industrial Activities Undertaken by Foreign Investors*, 50 M.L.R. (1987), pp. 583-585.

60. For the accident and its legal implications, see P.T. MUCHLINSKI, *ibid.*; see also D. BERGMAN, *The long Wait for Justice*, 140 N.L.J. 1990, p. 1747.

in the most demonstrative manner since funds for adequate compensation to the victims and their relatives could not easily be found⁶¹.

It appears, therefore, that tort creditors of a subsidiary company may be unfairly prejudiced by the application of limited liability in the parent-subsidary context. Although the parent company may be in charge of the operations of the subsidiary which have caused the damage, the latter's tort creditors have no recourse against the assets of the former even when the subsidiary is unreasonably undercapitalized.

B: CONCLUSION

Within the typical group of companies where all the subsidiaries are, almost invariably, directly or indirectly, wholly-owned by the parent and the parent exercises the actual management of the subsidiaries to a substantial degree, the limited liability of the parent becomes a rule without real significance.

Although it could be argued that limited liability motivates the parent company to extend and diversify its activities into new areas without risking all its resources, this is true only for a limited number of groups. Diversification of group activities is usually realized through the creation of managerial divisions and not through the creation of separate legal entities with limited liability. Even when a group expands geographically through the creation of new subsidiaries, these subsidiaries have rarely the character of capital raising devices but they are established mainly for the convenience of the group.

Also, the limited liability of the parent company for the debts of its subsidiary has an insignificant impact on the costs involved in the operation of the subsidiary. Due to the specific features of the typical group, i.e. the absolute ownership of the subsidiaries and their management by the parent, separation, information, capital raising costs as well as the costs involved in the operation of the securities markets, remain unaffected by the interposition of the limited liability of the parent.

Finally, the risk-shifting function of limited liability may have disastrous effects for the creditors of the subsidiary. In addition to the risks faced by creditors of a single, independent company,

61. See.

creditors of a subsidiary have to cope with additional risks arising out of the policy and practice of the typical group.

A typical subsidiary is subjected to the managerial control of the parent and its financial policy is designed in the group's headquarters so as to serve the interests of the group as a whole. The subsidiary's profits are often channelled towards the parent and the subsidiary's operations are mainly financed by way of loans by the parent that the subsidiary has to repay on demand. If, in the subsidiary's insolvency, the parent company elects to act as an external creditor, it can rank prior to the subsidiary's unsecured creditors who, as a result, remain unsatisfied. When this policy is accompanied by the apparent identification between parent and subsidiary, the problem becomes greater since credit may have been extended to a subsidiary upon the parent's credibility and reputation without due consideration of the subsidiary's own standing.

In these circumstances, creditors of the subsidiary may experience severe difficulties in protecting themselves. The protection currently afforded constitutes only a piecemeal response to the problems that they actually face. The lack of trade creditors' bargaining power and incentives, the problem of establishing that the parent company actually participated in the manufacturing of the defective product, the imperfections of the insurance markets, the limited scope of employees' protection and the practical inability of tort creditors to protect themselves, leave creditors of a subsidiary, as a class, exposed to uncompensated risks.

It can be concluded, therefore, that when the rule of limited liability protects a parent company within a typical group, limited liability serves no genuine interests apart from the interest of the group to create several layers of liability for its operations through the creation of subsidiaries. The advantageous economic functions of stimulating investment and cost-minimizing are almost absent and the function of risk-shifting is a source of uncompensated risks for a great number of creditors. On aggregate, it seems that, if the application of the rule was a matter of case-by-case policy considerations and not a matter of a misconceived legal consistency, limited liability should not apply in the typical parent-subsidiary context.

PART II: SEARCH FOR AN ALTERNATIVE RULE

The conclusions reached in the first part of the thesis could be summarized as follows:

1. Limited liability by no means constitutes a necessary attendant of incorporation. It emerged out of socio-economic necessities and can be more properly described as a privilege granted to investors in order to encourage them to participate in large trading associations over which they could not exercise a substantial degree of control.
2. Although limited liability shifts uncompensated risks to some creditors, it plays an important role for the economy as a whole when it is applied in the context of a single, independent company: it stimulates investment and it reduces the costs involved in the companies' operation.
3. The typical pattern of the absolute ownership and the close control of the subsidiary by its parent eliminates the positive effects of limited liability. In addition, the typical policies and practices of the group create a number of additional risks for a subsidiary's creditors.

It follows that the limited liability of the parent for the debts of its subsidiary does not constitute an optimal rule. It should either be replaced by another general rule which will be more responsive to the peculiarities of the parent-subsidiary relationship, or the applicable liability rule should be the result of a case-by-case consideration. In any event, the adherence to the current limited liability rule should be abandoned.

Senior group executives often undervalue the issue of the liability of the parent for the debts of its subsidiaries. They point out that the problem does not arise in practice because it is not in the interests of the group to leave the creditors of a particular subsidiary unsatisfied⁶². Almost all the group officials contacted took care to stress that the parent company would stand behind an insolvent subsidiary in the normal course of business in order to maintain the group's highest credibility and reputation⁶³. As the official of Unilever said "from our point of view limited liability is a nuisance. It has no relevance to business practice at all. We would not try to hide

62. See T. HADDEN, *Control of Corporate Groups*, 1981, IALS, p. 18.

63. See appendix, especially the last 2-3 questions of every interview.

behind it"⁶⁴. However, it was admitted that parent companies avoid saying that their policy is to stand behind the subsidiaries because they would not want to be legally committed.

It is significant that in half of the groups contacted the issue of the liability of the parent for the debts of its subsidiary has arisen. The parent companies of groups such as Shell, Unilever, Mitsubishi Electric, Canon and General Electric were asked, in various circumstances, to meet the liabilities of one of their subsidiaries. In the majority of the cases, all liabilities were met, but exceptionally, parent companies refrained from doing so, because they considered they had no real responsibility for the collapse of their subsidiary.

The existence of cases like the Cape Industries and the Multinational case⁶⁵, clearly indicates that parent companies are not always apt to support a subsidiary in difficulties. In these cases, creditors of the subsidiary sought to obtain satisfaction by the parent companies concerned but satisfaction was denied, although the responsibility of the parent was beyond any doubt.

Therefore, the statements of the officials that parent companies do not shield behind limited liability merely indicate the customary tendency of parent companies to support their subsidiaries, or at the most, what should be the correct group policy. But by no means do they constitute an accurate description of the actual behaviour of parent companies. The actual state of English law allows parent companies to shield behind limited liability, and if need be, use will be made of it to the detriment of the subsidiary's creditors. Statements of a moral character cannot substitute for a legal principle which should clearly define the liabilities of the parent in the event of the failure of its subsidiary.

Halpern, Trebilcock and Turnbull suggested that "the unlimited liability regime ... would seem more responsive to many of the parent-subsidiary and affiliated problems"⁶⁶.

Instead of a general rule of unlimited liability, Landers proposed that in all cases:

- "1) the parent's debt in its affiliate should always be subordinated
- 2) creditors of the subsidiary should be able to pierce the veil of the parent; and

64. Appendix, III, qu. 12.

65. See below, ch. VI, B.

66. P. HALPERN, M. TREBILCOCK, ST. TURNBULL, *op. cit.*, p. 150.

3) if both parent and subsidiary are bankrupt, the estates should be consolidated and all creditors should share equally"⁶⁷.

In the U.K., all the members of the Cork Committee recognized the need for a change of the existing law on the issue, which in principle, preserves the limited liability of the parent for the debts of its subsidiary. However, the Committee was reluctant to propose a radical change because of "the enormous complexities of the subject". The impact of a change on entrepreneurial activity, the treatment of partly owned-subsidiaries, the position of the creditors of the parent company, the issue of territoriality, all these were the factors that prevented the Committee from proceeding into a thorough revision of the matter; however, the Committee expressed its wish "to see such a revision undertaken as a matter of urgency"⁶⁸.

Unfortunately, so far such a revision has not been undertaken. The issue of the imposition of liability on the parent for the debts of its subsidiary has not yet attracted sufficient attention from the legislative authorities. On the other hand, the English case law on the issue has not followed the development of its counterpart in the United States; there are very few English decisions that directly address the problem. At the European Community level, the expectations raised by the draft proposal for a Ninth Directive concerning the conduct of groups of companies, have not yet been fulfilled and no further development of this draft is expected in the foreseeable future.

Therefore, to proceed to an elaboration of a solution to the problem, one is bound to draw useful analogies and conclusions from the few relevant cases and from these statutory provisions which directly or indirectly address the problem in major legal systems.

67. J.M. LANDERS, *Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy*, op. cit., p. 528; the proposals are analyzed in J.M. LANDERS, *A Unified Approach To Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 *Univ. Chi. L. R.* 1975, p. 589.

68. *Insolvency Law Review Committee, Insolvency Law and Practice*, Cmnd. 8558, (1982), par. 1952; see also concluding chapter, i.

CHAPTER V: THE GROUP PHENOMENON IN VARIOUS LEGAL AREAS

The substitution of the traditional single company by the group of companies, as the predominant form of business organization, raises a number of problems for the regulatory and the legislative authorities. The law, in general, adopts a rather piecemeal approach in coping with these problems. There is not a specific and comprehensive set of rules regulating in a consistent way all the aspects of operation of a group of companies. Depending on the objectives sought, each different legal sector adopts its own perception of the group and links the existence of a group with a number of various consequences. Consequently, one cannot speak of a group of companies law, but rather of a set of rules and principles which constitute parts of what may be conventionally called, the legal regulation of groups of companies.

There is a number of different legal sectors which are interested to regulate the various aspects of the operation of the group. The different sectors have shown a varying degree of readiness and flexibility in adapting to the new reality.

Company law, in particular, makes extremely slow steps of adaptation to the group phenomenon. Its philosophy and its structure is still based on the concept of the firm which is organized in the form of an independent single-unit company. The predominant principle is still that every company is an independent entity with its own interests, its own management, its own profits and its own liabilities. The concept of the separate legal personality of the company, alongside with the limited liability rule, almost precludes the recognition of the group as one economic unit and the bestowal of legal significance to the main group feature, i.e. the exercise of uniform central management by the parent.

In contrast, the law relating to taxation and accounting of companies has proved more flexible in recognizing the reality of the group consisting of parent and subsidiary companies. To cope with practices such as transfer pricing and internal lending which may reduce the group's

overall tax liability and may provide third persons with misleading records¹, tax authorities and accountants developed a number of protective techniques and measures. The common characteristic of these techniques and measures is that they are founded upon the recognition of the group as a single economic unit where the management is exercised centrally by the parent company.

The operation of groups of companies also presents problems for legal areas such as Private International Law, Competition Law and Labour Law. In these areas the perception of the group as a single unit is not as developed as in the areas of accounting and taxation. However, there are many legislative and judicial instances where account has been taken of the unique features of the group and especially of the management of the subsidiary by its parent, and certain consequences were linked to it.

A: THE LAW RELATING TO ACCOUNTING

The accounting profession was the first that tried to cope with the emerging reality of groups of companies. The peculiar characteristic of the disclosure of the group's affairs stems from the fact that the provision of accurate and comprehensive information concerning the financial position of a company belonging to a group, is essential not only for its own shareholders and management, but also for present and future shareholders as well as the management of the other group companies together with their creditors, customers and employees. More importantly, this information is of great interest to the general public consisting of the group's competitors, the business and financial press, investments analysts, etc².

However, the usual policy of the group to transfer funds from one company of the group to another through intra-group transactions - mainly borrowing and transfer pricing³- distorts the picture of the real performance of a company belonging to the group. The company's accounts do not give a true and fair view of its financial condition and, as a result, the various interested parties may be misled into believing that the company is in a better or in a worse condition than the actual one.

1. See D.M. HARE & A.T. ARCHIMANDRITOU, *Intra-Group Transactions - The Importance of Disclosure*, J.B.L. 1986, p. 249.

2. W. MULLER, *Group Accounts under the Proposed Seventh EEC Directive: A Practitioner's View*, in K. HOPT (ed.), *Groups of Companies in European Laws (Legal and Economic Analyses on Multinational Enterprises; vol. 2)*, 1982, p. 175.

3. T. HADDEN, *Control of Corporate Groups*, 1981, pp. 15-18; S. PLASSEHAERT, *Transfer Pricing and Multinational Corporations: an overview of concepts, mechanisms and regulations*, 1979; OCDE Report on Transfer Pricing (1979 and 1984).

As early as in the first quarter of this century, it was realized that the accounts of a company belonging to a group do not themselves provide an accurate picture of the company's performance. Users of accounts would be more interested in the performance of the group as a whole. Accordingly, and in order "to set-off or eliminate all intra-group transactions, notably internal loans and internal trading, and thus to present a true and fair view of the assets and liabilities and trading performance of the group as a whole"⁴, a new kind of accounts was considered to be necessary.

These accounts are now called consolidated accounts and present the information contained in the separate financial statements of a parent company and its subsidiaries as if they were a single entity's financial statements. In their simplest form, they comprise the consolidated balance sheet dealing with the state of affairs of the group as a whole and the consolidated profit and loss account dealing with the aggregate profit or loss of the group⁵.

Although the practice of consolidation became common much earlier⁶, in the UK it was statutorily imposed by the CA 1948⁷ and in other European countries even later⁸. In the UK, the first group to prepare consolidated accounts seems to have been Nobel Industries in 1922⁹. The same year, the published lecture of a recognized professional, Sir Gilbert Garnsey¹⁰, had a strong impact on the business community since he openly suggested that users of accounts are more interested in observing the performance of the group as a whole. Also, cases concerning misrepresentation of the group's financial condition through the accumulation of secret reserves by subsidiaries¹¹ convinced the business community of that time that consolidated accounts were necessary.

4. HADDEN, *ibid.*, p. 26.

5. For a comprehensive view on consolidated accounts, see J. BOUGH, *Company Accounts*, 1987, pp. 157-170.

6. Consolidated accounts first appeared in the United States towards the end of the previous century, as a result of the great public concern for the control of monopolistic trends that a very strong wave of mergers generated during that period. See R. LIEFMANN, *Holding Companies in Europe*, *Encyclopedia of the Social Sciences*, Vol. VII (1934-1935), p. 410; R.H. PARKER, *Explaining National Differences in the Consolidated Accounts* in T.A. LEE & R.H. PARKER, *The Evolution of Corporate Financial Reporting*, 1979, p. 124.

7. S. 150.

8. See R.H. PARKER, *op. cit.*

9. It is argued, however, that the practice of consolidation appeared even earlier. See J.R. EDWARDS & K.M. WEBB, *The Development of Group Accounting in the UK to 1933*, *The Accounting Historians Journal*, Vol. II, Spring 1984, p. 38.

10. J.R. EDWARDS & K.M. WEBB, *ibid.*, p. 48.

11. Mainly the Royal Mail case; see J.R. EDWARDS & K.M. WEBB, *ibid.*

In the domestic and in the European Community level, continuous efforts to oblige groups to present accounts which give a true and fair view of their world-wide operations, resulted in the introduction of the International Accounting Standard III¹² concerning consolidated financial statements and the Seventh Directive on Consolidated Accounts¹³ which was recently implemented in English law¹⁴ and is wholly or partially implemented in almost all the other member states¹⁵.

International Accounting Standard III "asserts as the need for consolidated financial statements that certain parties with interests in the parent company of a group, such as present and potential shareholders, employees, customers, and in some circumstances creditors, are concerned with the fortunes of the entire group and, consequently, need to be informed about the results of operations and financial position of the group as a whole. This need is served by consolidated financial statements, which present financial information concerning the group as that of a single enterprise without regard for the legal boundaries of the separate legal entities"¹⁶.

In the Explanatory Memorandum to the Proposal for a Seventh Directive, it was stated that "the basic characteristic of ... groups is that the management of the companies belonging to them is coordinated in such a way that they are managed on a central and unified basis by the dominant company or companies in the interest of the group as a whole"¹⁷. Thus, as it is felicitously pointed out, "the true economic and financial position of an individual company belonging to a group can only be assessed against the background of the overall position of the group"¹⁸.

Accordingly, the Seventh Directive requires a parent undertaking to prepare a consolidated balance sheet, a consolidated profit-and-loss account and notes on the accounts. These accounts shall give a true and fair view of the assets, liabilities, financial position and profit or loss of

12. Accounting Standards or, as they are formally called Statements of Standard Accounting Practice (SSAPs) are issued by the Accounting Standards Committee with the object of working towards the uniform providing of a true and fair view of a company's financial state. Although these standards do not have a binding legal effect, they are considered by the courts as providing a standard method of preparing accounts and any departure from the standard will require explanation. See J. DINE, *Company Law*, 1991, p. 156.

13. Council Directive (EEC) 83/349 (OJ L193 18.7.83 p1).

14. CA 1985, § 227(1).

15. Only Ireland is not yet at the stage of producing draft legislation. For the implementation of the Seventh Directive in other member states, see S.J. GREY & A.G. COENENBERG (ed.), *International Group Accounting*, 1988 and S.J. GREY, A.G. COENENBERG, P.D. GORDON (ed.), *International Group Accounting*, 1993.

16. DAVID FLINT, A True and Fair View in Consolidated Accounts, in S.J. GREY & A.G. COENENBERG (ed.), *International Group Accounting*, 1988, p. 15 at 29.

17. Bulletin of the E.C., Supplement 9/76, 19.

18. W. MULLER, *op. cit.*, p. 176.

the undertakings included in the consolidation as if the undertakings were a single undertaking¹⁹.

The Seventh Directive was recently implemented in the UK by the Companies Act 1989, s 5(1) which substituted CA 1985 s 227(1) and (2). According to the new provision, parent companies are, with certain exceptions, required to consolidate in their accounts all subsidiary undertakings²⁰. Since the Directive is at present implemented in all member states, consolidated accounts currently constitute a widespread and effective means of dealing with the group as a single unit, centrally controlled by the parent company²¹.

B: THE LAW RELATING TO TAXATION

The taxing authorities throughout the world have a certain interest in adapting their rules to the reality of groups of companies. All governments are interested in assessing the true performance of a business entity in order to impose an amount of tax that corresponds to its real income.

It is evident that the structure of a multinational group of companies enables it to pass taxable income from one jurisdiction to another. By borrowing and lending within the group, by transfer pricing²², and by the payment of excessively high or low dividends and management fees, the group's headquarters are in a position to control the extent of the tax liability of every company belonging to the group. As a result, the group as a whole has the ability to take advantage of the various existing tax regimes throughout the world and to minimize its overall tax liability²³.

To cope with practices of this kind, tax authorities have introduced methods by the use of which they can estimate the real tax base of a company belonging to a group. The most commonly

19. Council Directive (EEC) 83/349, op. cit., arts. 1, 16, 26.

20. For the definitions of parent and subsidiary employed in the provision, see below, ch. VII, A, i.

21. However, Hadden suggests that consolidated accounts in their current form do not serve the interests of the business community satisfactorily. He proposes an alternative form of group accounts that will provide comprehensive information not only for the group companies but for the group's various divisions, as well. See T. HADDEN, op. cit., pp. 27-29.

22. "Transfer pricing is that practice whereby the MNE, in its intra-enterprise transactions, can sometimes effectively modify the tax base on which its entities are assessed, or possibly avoid exchange controls, by "doing business" within the MNE structure itself, so as to reallocate costs and revenues in such a way that its profits are realized where the tax and exchange environment is most favourable." C. WALLACE, *Legal Control of Multinational Enterprises*, 1982, p. 127.

23. T. HADDEN, op. cit., ch. 2 and appendices; also, *supra*, ch. III, B, ii, a and c.

used method is based upon the arm's length principle. According to this principle, all the transactions between two companies within the same group are expected to be conducted at arm's length. The price available in the open market, i.e. the price charged by an independent seller to an independent buyer, has to be charged in exchange for the goods or services transferred from one company of the group to another. Where the terms of an intra-group transaction differ significantly from those prevailing in the open market, the tax authorities will ignore the terms agreed and will treat the transaction as if it has been carried out in the open market²⁴.

The approach that profits of a company, which enters into transactions with companies of the same group located outside of the jurisdiction of the taxing authorities, should be calculated according to the arm's length principle, is taken in article 9(1) of the OECD Model Double Taxation Convention of 1977²⁵. The arm's length principle is currently employed by the tax authorities of countries such as the US, the UK, France, Germany and Greece²⁶, although in different forms and variations²⁷. Nevertheless, there are some difficulties in the application of the method, for instance, in finding out the market price of a product or a service which is not traded in the open market and in determining the exact location where certain income has to be taxed²⁸.

Several states of the US employed an alternative method in order to determine the real tax base of a company belonging to a group. This method was called worldwide combined reporting and it was based upon the unitary business principle²⁹. It computed the taxable base of a company belonging to a group by adding the income of all the companies of the group which comprised a unitary business enterprise, wherever they were located. The taxable income in one state was apportioned by the use of a formula based upon a percentage calculation of three types of business income: sales, property and payroll. In the last stage, the average figure was

24. PLASSEHAERT, *op. cit.*, appendix II, para. 11.3 et seq; A. KRAGEN & J. McNULTY, *Federal Income Taxation*, Vol. II, *Taxation of Corporations*, 1981, pp. 62-75.

25. FR. WOOLDRIDGE, *Groups of Companies: The Law and Practice in Britain, France and Germany*, IALS, 1981, pp. 82 and 159 (the full text of the article); see also K. MESSERE, *OECD: Report on Transfer Pricing and Multinational Enterprises*, Intertax 1979, p. 288.

26. See US International Revenue Code, s. 482; UK Income and Corporation Taxes Act 1988, s. 770; *Code général des impôts*, ss. 57 and 238(A); art. 1 of the *Außensteuergesetz* of 1972; art. 55 of the Greek Law n. 1041/80. For a general view on anti-transfer-pricing measures, see FR. WOOLDRIDGE, *op. cit.*, pp. 81-106.

27. For the forms and variations of the arm's length principle, see *National Legislation and Regulations Relating to Transnational Corporations*, U.N. Commission on Transnational Corporations, 2nd sess., Lima, 1-12 March 1976, U.N. doc. no. E/C.10/8.

28. See S. LALL, *The Multinational Corporation* (1980), ch. 6.

29. For the states where the unitary tax principle was used, see T. PEARSON, *State Taxation of Foreign Source Income through Worldwide Combined Reporting*, 17 *Vanderbilt Journal of Transnational Law* 1984, p. 99.

multiplied with the overall taxable income of the group and the outcome was the portion of income to be taxed by the particular state³⁰.

The worldwide combined reporting method was adopted in 1957, by the National Conference of Commissioners on Uniform State Law and it was enacted in the Uniform Division of Income for Tax Purposes Act (UDITPA), adopted by 25 States³¹. According to the Act, the income of subsidiaries, as well as the income of branches and divisions, irrespective of the state of location, was included in the calculation of the corporate taxpayer's income to the extent that they constituted part of a unitary business³².

The Act did not define the concept of the unitary business and, therefore, it was left to the states to determine the scope of the Act for themselves. The interdependence of the group's operating companies, the centralization of corporate management and corporate staff personnel, the mutual benefit which various companies of the group derived from each other, the essentiality of one part of the group to the other parts, and the overall impact of a particular company on the economic performance of the whole group, were the most common criteria used by the different states to define what constitutes a unitary business³³.

Originally, the method was expected to be used only for the taxation of US groups doing business in more than one US states. However, as many as 13 states extended the unitary business concept so as to include foreign corporations doing business in their territories through a parent or a subsidiary company³⁴. So, if a company belonging to a multinational group existed in one of these states, the income of the whole group throughout the world had to be reported to its tax authorities for the purposes of the unitary method.

In many instances, the US Supreme Court ruled that a state is allowed to tax the activities of a company's foreign affiliates when the domestic company and its foreign affiliates comprise

30. For a comparison of the method with the arm's length principle, see S. SURREY, *Reflections on the Allocation of Income and Expenses among National Tax Jurisdictions*, 10 *Law and Policy in International Business* 1978, p. 409. For a criticism of the method, as it was used in California, see E. PETERSEN & F. WALSH, *US: The Impact of the California Unitary Business Concept on the Taxation of Multinational Corporations*, *Intertax* 1978, p. 107.

31. See R. HEISING, *Container Corporation of America v FTB: The Constitutionality of State Power to tax Multinational Corporations*, 16 *Law and Policy in International Business* 1984, p. 299.

32. PH.I. BLUMBERG, *The Law of Corporate Groups: Procedural Problems in the Law of Parent and Subsidiary Corporations*, 1983, p. 439.

33. See W. HELLERSTEIN, *State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon, and H.R. 5076*, 79 *MICH. L. R.* 1981, p. 113 at 149; see also PH. BLUMBERG, *op. cit.*, pp. 441-442.

34. These states were Alaska, California, Colorado, Idaho, Illinois, Indiana, Massachusetts, Montana, New Hampshire, New York, North Dakota, Oregon and Utah. See R. HEISING, *op. cit.*, pp. 303-304, fn. 27.

parts of a unitary business. In cases such as Mobil Oil Corp. v. Commissioner of Taxes³⁵, Exxon Corp. v. Wisconsin Department of Revenue³⁶ and Container Corp. of America v. Franchise Tax Board³⁷, the court considered various factors before deciding in favour of the existence of a unitary business, such as the power of the domestic corporation to control the activities of the overseas subsidiary and the actual exercise of that power, the close integration between parental and subsidiary business and the considerable volume of intra-group transfers of personnel, capital, goods and services³⁸.

Notwithstanding the acceptance by the courts and the generation of additional tax revenue for state governments³⁹, the application of the unitary business principle for the taxation of foreign companies gave rise to strong international reaction. Complaints from multinational enterprises as well as protests from foreign governments and international organizations like ICC, OECD and the International Fiscal Association exercised pressure on US to repeal the unitary tax statutes⁴⁰. They were finally repealed as a source of conflict with foreign nations and as a threat to the conduct of a uniform US foreign policy⁴¹.

Nevertheless, the method based on the unitary business concept as well as the method based on the arm's length principle are both characterized by a realistic approach towards groups of companies. Both methods, and especially the former, transcend the legal barriers created by the separate corporate personalities of the different companies of the group, and, to a great extent, treat the group as a single unit for the purposes of taxation⁴².

35. 445 U.S. 425 (1980).

36. 447 U.S. 207 (1980).

37. 103 S. Ct. 2933 (1983).

38. For an overview of these cases, see D. ARONOFSKY, *Piercing the Transnational Corporate Veil: Trends, Developments, and the Need for Widespread Adoption of Enterprise Analysis*, 10 N.C.J. Int'l L. & Com. Reg., 1985, p. 31, at 61 et seq.

39. It is estimated, for instance, that California generated at least an extra 500 million dollars of tax revenue each year; in general, it is regarded that a corporation in a state using worldwide combined reporting was paying more state income tax than a corporation in a state using the arm's length principle. See T. PEARSON, *op. cit.*, pp. 96-97.

40. See C. LINDENCRONA, *What is wrong with Unitary Taxation*, in K. HOPT (ed.), *Groups of Companies in European Laws*, 1984, p. 234; P. WINSHIP, *State Taxation of Multinational Business: The Unitary Tax Debate*, J.B.L. 1985, p. 179; *Amicus Curiae Brief of the US in Alkan Aluminium Ltd. v FTB of California*, 25 ILM 1986, p. 688; 25 ILM 1986, pp. 734-739.

41. See 25 ILM 1986, pp. 750-762; FINANCIAL TIMES, 6/9/1986, pp. 4, 20.

42. See also ss. 402 and 403 of the Income and Corporation Taxes Act 1988, which enable losses of one member of a group to be set against the profits of another; J.H. FARRAR, N.E. FUREY, B.M. HANNIGAN, *Farrar's Company Law*, 3rd ed., 1991, pp. 300-301.

C: PRIVATE INTERNATIONAL LAW

In the field of Private International Law, one is confronted with the issue of determining the jurisdiction where the group as a whole or its constituent parts should be subjected to. The courts are typically asked to take jurisdiction over a foreign company belonging to a group on the basis of its presence in the jurisdiction through a domestic company of the same group. The factor often relied upon by the courts in order to establish presence is the control of the foreign parent over its domestic subsidiary.

The American courts have dealt extensively with the issue; sometimes they concluded that the degree of control exercised by the foreign parent was sufficient to subject it to the jurisdiction of the subsidiary and sometimes they concluded otherwise.

The leading case in the area is Cannon Manufacturing Co. v. Cudahy Packing Co.⁴³. In that case, concerning a breach of contract action by a North Carolina corporation against a Maine corporation, the Court refused to assume jurisdiction over the defendant on the basis of its presence in Alabama through a wholly-owned subsidiary, although it was found that the operations of the subsidiary were controlled by the parent as if the subsidiary was an unincorporated branch or department⁴⁴. The Court stated that "Congress has not provided that a corporation of one state should be amenable to suit in the federal court ... whenever it employs a subsidiary corporation as the instrumentality for doing business therein"⁴⁵. Although the Cannon case involved purely domestic parties, the same result was often reached by the courts in similar cases involving foreign companies⁴⁶.

On the contrary, in the case of Bulova Watch Co. v. K. Hattori & Co.⁴⁷, involving the legal action against a Japanese conglomerate for unfair competition by its American subsidiaries, the court found that the control exercised by the parent was sufficient to establish jurisdiction of the American courts. Judge Weinstein significantly noted that "these subsidiaries almost by

43. 267 U.S. 333 (1925).

44. *Ibid.*, at 335.

45. *Ibid.*, at 336.

46. For instance, in the cases of Hargrave v. Fibreboard Corp., 710 F.2d 1154 (5th Cir. 1983) and Cramer Motors Inc. v. British Leyland Ltd., 628 F.2d 1175 (9th Cir. 1980), concerning an action for products liability and an illegal conspiracy action, respectively, the court refused to assume personal jurisdiction over the British parent companies on the ground of lack of extensive control over the domestic subsidiaries.

47. 508 F. Supp. 1322 (S.D.N.Y. 1981).

definition are doing for their parent what their parent would otherwise have to do on its own"; so he concluded that "the subsidiaries's presence substitutes for the presence of the parent"⁴⁸.

In the case of Copiers Typewriters Calculators Inc. v. Toshiba Corp.⁴⁹, involving a breach of contract and warranty action, the court assumed jurisdiction over Toshiba of Japan because it conducted business in the United States and obtained substantial profits through its American wholly-owned subsidiary. The court held that where the parent must approve significant domestic subsidiary decisions, exercising jurisdiction over the parent is appropriate⁵⁰.

In the case of Roorda v. Volkswagenwerk, A.G.⁵¹, the plaintiff sued the German defendant (VWAG) for injuries caused in California by an allegedly defective car. The court determined that the defendant was present in the United States for jurisdictional purposes through Volkswagen of America (VWOA), its American importer. In supporting its decision, the court noted:

"When a foreign parent corporation so pervasively controls the activities of its subsidiary as the control exercised here by VWAG over VWOA, and consideration is given to the tremendous benefits from the business obtained through such a relationship, a foreign corporation like VWAG should not be heard to complain about the burden of defending litigation in this forum".⁵²

The European Court of Justice has, on two occasions, assumed jurisdiction over a foreign parent on the ground of its domination over the European subsidiary. In the case of I.C.I. and Others v. Commission⁵³, concerning the challenge of concerted increases in prices under art. 85 of the EEC Treaty, I.C.I. of England, the parent company of the I.C.I. group, had a subsidiary within the EEC territory. The fact that the subsidiary, "although having a distinct corporate personality does not determine its behaviour in the market in an autonomous manner but essentially carries out instructions given to it by the parent company"⁵⁴, led the Court to impute the activities of the subsidiary to the parent and, accordingly, to subject I.C.I. of

48. *Ibid* at 1342.

49. 576 F. Supp. 312 (D. Md. 1983).

50. *Ibid.* at 320, 324.

51. 481 F. Supp. 868 (D.S.C. 1979).

52. *Ibid.* at 881.

53. C.M.L.R. [1972], p. 557.

54. *Ibid.*, at 629.

England to the jurisdiction of the EEC authorities at a time when the UK had not yet joined the EEC.

In the case of Commercial Solvents Corp'n. v. Commission⁵⁵, concerning the challenge of a refusal to sell under art. 86 of the Treaty, the "obviously united action" of parent and subsidiary, as well as the power of control of the former over the latter⁵⁶, led the Court to exercise jurisdiction over the American parent company, treating it as doing business within the Community through its subsidiary.

The traditional basis of jurisdiction of the English courts over a company is its presence in England. A company is deemed present and subject to the jurisdiction of the English courts either if it is registered under the Companies Act 1985 or, in the case of a foreign company, if it establishes a fixed and definite place of business in England⁵⁷ and the business is conducted on behalf of the foreign company⁵⁸.

This principle was stated by Pearson J. in Jabbour v. Custodian of Absentee's Property of State of Israel⁵⁹:

"A corporation resides in a country if it carries on business there at a fixed place of business, and, in the case of an agency, the principal test to be applied in determining whether the corporation is carrying on business at the agency is to ascertain whether the agent has authority to enter into contracts on behalf of the corporation without submitting them to the corporation for approval."

Normally, there can be no question that the English branch office of a foreign company acts on behalf of the foreign company. If, however, the foreign company has appointed an agent in England, it will not always be clear whether the agent conducts business on his own behalf or on behalf of the foreign company. If the agent has authority to enter into transactions binding upon the foreign company, it is generally considered that he acts on behalf of the company and the company is, therefore, present within the jurisdiction. If, on the contrary, the agent never

55. [1974] 1 C.M.L.R. 309.

56. *Ibid.*, at 344.

57. In this case, the foreign company has to register a person authorized to accept service of legal process in accordance with section 691(1) (b) (ii) of the Companies Act 1985.

58. P.M. NORTH & J.J. FAWCETT, *Cheshire and North's Private International Law*, 12th ed., 1992, pp. 186-188.

59. [1954] All ER 145 at 152.

makes contracts which bind the foreign company but merely acts as a conduit transmitting offers abroad for acceptance, the company is not considered present in the jurisdiction⁶⁰.

Likewise, the presence of a domestic subsidiary is not sufficient to assume jurisdiction over the foreign parent unless it is proved that the subsidiary is doing business in the jurisdiction on behalf of the parent; the authority of the subsidiary to bind the parent contractually will be an important factor in determining this⁶¹.

In the recent case of Adams v. Cape Industries plc.⁶², the issue was the enforcement of a judgement of the Tyler Division in Texas against the English parent company of a United States subsidiary. The plaintiffs relied on the common law rule that a judgement in personam of a foreign court of competent jurisdiction could be sued on in England as creating a debt between the parties. They contended that the Texas court was a court of competent jurisdiction because the defendants "had been resident in the US ... by virtue of being then present and carrying on business in the US ... through their US subsidiary"⁶³.

Upholding the decision of Scott J. in the Chancery Division, the Court of Appeal concluded:

"Since there was no evidence that the subsidiary ... had ever effected any transactions in such a manner that the defendants [the parent] had thereby become subject to contractual obligations to any person, the business carried on by the subsidiary ... was exclusively [its] own business and not that of the defendants [the parent] ... [I]n those circumstances the court would not lift the corporate veil so that the presence of the subsidiary ... could be treated as the presence of the defendants. It followed that the defendants had no presence in Illinois through their subsidiary ... at any material time."⁶⁴

If those in charge of the group structure preferred to carry out the same operation in the United States through a branch instead of the subsidiary, the judges would not have hesitated to hold

60. Okura & Co. Ltd. v. Forsbacka Jernverks Aktiebolag, [1914] 1 K.B., 715; Vogel v. R and A Kohnstamm Ltd., [1973] Q.B., 133; BHP Petroleum Pty Ltd. v. Oil Basins Ltd., [1985] V.R. 725 at 731-734.

61. P.M. NORTH and J.J. FAWCETT, *op. cit.*, p. 188; see also, J.J. FAWCETT, *Jurisdiction and Subsidiaries*, 1985 J.B.L. p. 16, at 17, 20; CL. SCHMITTHOFF, *Group Liability of Multinationals*, in SIMMONDS (ed.) *Legal Problems of Multinational Corporations*, 1977, p. 71, at 76.

62. [1990] 2 W.L.R. 657, also discussed in ch. VI, B, i.

63. *Ibid.*, at 657-658.

64. *Ibid.*, at 659.

that the parent company was present in the United States by virtue of carrying on business there⁶⁵. Nevertheless, the fact that the same operation was carried out by a wholly-owned subsidiary enabled the parent company to avoid the enforcement of the American judgement and the resulting liability.

For Professor Schmitthoff, the avoidance of jurisdiction through the creation of a subsidiary instead of a branch is, "indeed a strange result"⁶⁶. He suggested that "the courts and authorities of the host country should assume jurisdiction over the parent company if it carries on substantial business in the host country, by means of wholly-owned or controlled subsidiaries or branch offices"⁶⁷. For North and Fawcett, "the current law still places undue reliance on traditional notions of agency". They suggest that "if the parent and subsidiary form one economic unit it should be possible to found jurisdiction against the foreign parent on the basis of the presence of its subsidiary in England"⁶⁸.

These suggestions were partially met by virtue of the Civil Jurisdiction and Judgements Act 1982 (C.J.J.A.). This Act gave effect to the Brussels Convention on Jurisdiction and Enforcement of Judgements in Civil and Commercial Matters of September 27, 1968⁶⁹ and became fully operative in January 1987.

Where a defendant company is "domiciled" in a Contracting State the bases of jurisdiction under the Convention will apply and not the traditional rules of jurisdiction of the forum⁷⁰. The general basis of jurisdiction is provided for by article 2 of the Convention, according to which "persons domiciled in a Contracting State shall, whatever their nationality, be sued in the courts of that State". Thus, an English court can assume jurisdiction over a company if that company is "domiciled" in the UK. For the purposes of C.J.J.A., domicile of the company is regarded the country in which the company has its seat⁷¹ and a company is regarded as having its seat in the UK if:

65. *Ibid.*, pp. 964, 1031.

66. CL. SCHMITTHOFF, *op. cit.*, p. 77.

67. *Ibid.*, p. 82.

68. P.M. NORTH and J.J. FAWCETT, *op. cit.*, p. 188.

69. OJ 1978, L 304 pp. 77, 97. The purpose of the Convention is to provide for the free circulation of judgements throughout the Community, thereby inspiring business confidence and generally encouraging the right conditions for trade. See P.M. NORTH and J.J. FAWCETT, *op. cit.*, pp. 279-280, 411-413.

70. All European Community States are now Contracting States to the Convention: i.e. Belgium, Denmark, Germany, France, Italy, Luxembourg, the Netherlands, the United Kingdom, Ireland, Greece, Spain and Portugal.

71. C.J.J.A., s. 42(1).

- a) it is incorporated or formed under the law of a part of the UK and has its registered office or some other official address in the UK; or
- b) its central management and control is exercised in the UK⁷².

Under the above provisions, a foreign branch of a UK company is subject to the English jurisdiction since its central management and control is expected to be exercised in the UK. A foreign subsidiary of a domestic parent company is subject to the jurisdiction of the English courts only if it is proved that the parent company exercises central management and control⁷³. In ascertaining where central management and control is exercised, it is relevant to look at where the directors are resident, hold meetings and decide major issues⁷⁴.

Apart from the general jurisdiction based on the criterion of "domicile", the Convention introduces some special bases of jurisdiction. According to art. 5(5) of the Convention, a company domiciled abroad may be subjected to the jurisdiction of the English courts, when the dispute arose out of the operation of a branch, agency or other establishment of the company in the U.K. In a number of cases⁷⁵, the European Court of Justice has decided that the "branch", "agency" and "other establishment" must: (i) have a permanent place of business, (ii) be subject to the direction and control of the parent, (iii) have a certain autonomy, (iv) act on behalf of and bind the parent⁷⁶.

In Sar Schotte GmbH v. Parfums Rothschild SARL⁷⁷, the European Court of Justice had to consider whether the term "establishment" in art. 5(5), covers a body with separate legal personality. In that case, the defendant was a French wholly-owned subsidiary of a German company. The plaintiff wished to sue the defendant in Germany on the basis that the German parent company was an "establishment" of the French subsidiary. The two companies had the same name and identical management, and the parent company negotiated and conducted business in the name of the subsidiary as if it was a mere department of the latter's business. On this evidence, the Court of Justice held that art. 5(5) would apply, even though the German company was a separate legal entity.

72. C.J.J.A., s. 42(3).

73. C.J.J.A., s. 42(3)(b).

74. The Rewia [1991] 1 Lloyd's Rep. 69 at 74; on appeal the decision was overruled on other grounds, [1991] 2 Lloyd's Rep. 325, CA.

75. Case 14/76 De Bloos v. Bouyer [1976] E.C.R. 1497, [1977] 1 C.M.L.R. 60; Case 33/78 Somafer v. Saar Ferngas [1978] E.C.R. 2183, [1979] 1 C.M.L.R. 1490; Case 139/80 Blanckaert and Willems v. Trost [1981] E.C.R. 819, [1982] 2 C.M.L.R. 1.

76. See P.M. NORTH and J.J. FAWCETT, *op. cit.*, pp. 303-305.

77. Case 218/86 [1987] E.C.R. 4905.

Accordingly, art. 5(5) could apply in the more common situation where a parent company carries on business in another country through its subsidiary, and the parent would then become subject to the jurisdiction of the courts of the country where the subsidiary is located.

In France and Germany, where the Brussels Convention also applies, the traditional rule is that the domicile of the company is the place where it has its "real seat" (*siège réel, tatsächlicher Sitz*), an expression generally understood as being the place where it has its central administration. Thus, if a foreign subsidiary has no real independence and it is operating under the absolute supervision of a French or a German parent company, jurisdiction may be assumed over the subsidiary on the basis that the real domicile of the subsidiary is that of its parent company even though the seat indicated in the articles is different⁷⁸.

In general, therefore, a domestic court may assume jurisdiction over a foreign company belonging to a group on the basis of the existence in the jurisdiction of another company belonging to the same group. When this happens, the main criterion relied upon by the legislatures and the courts is the existence of a dependency relationship between the two companies. When the parent company is the real decision-making centre of the subsidiary, a foreign subsidiary may be subjected to the jurisdiction of a domestic parent and, sometimes, a foreign parent may be subjected to the jurisdiction of a domestic subsidiary.

D: COMPETITION LAW

The objective of Competition Law is the efficient and fair operation of the market. The special problem that may arise in this area from the operation of groups of companies is that a cooperation between companies belonging to the same group can lead to practices which distort the efficient and the fair operation of a particular market. To deal with this problem, US antitrust and EEC competition laws have often been applied extraterritorially to regulate anticompetitive conduct originated from abroad but which had effects within the jurisdiction by virtue of arrangements between two companies belonging to the same group.

78. S.N. FROMMEL, *Taxation of Branches and Subsidiaries in Western Europe, Canada and the USA*, 2nd ed., 1978, pp. 118-136; R. HOUIN, *Les Groupes de Sociétés en Droit Français*, in K. HOPT (ed.), *Groups of Companies in European Laws*, 1982, 45, at 50; H. WIEDEMANN, *Gesellschaftsrecht*, Vol. 1, 1982, p. 782 et seq.

In the United States, antitrust legislation has traditionally been directed towards locally incorporated companies. However, there were several instances where the laws applied extraterritorially, through the home parent company to its foreign affiliates⁷⁹.

In United States v. Aluminum Co. of America (Alcoa)⁸⁰, an international cartel arrangement between French, Swiss, British and Canadian aluminium producers, was organized and concluded abroad and did not even involve directly an American company. Nevertheless, the court determined that the Sherman Act could be applied extraterritorially to govern the conduct of the Canadian company involved in the agreement on the basis that company was a subsidiary of the defendants, an American company. The dictum of Justice Learned Hand initiated the so-called "effects" doctrine⁸¹:

"It is settled law that any state may impose liabilities, even upon persons not within its allegiance, for conduct outside its borders which the state reprehends; and these liabilities other states will ordinarily recognize."

In Continental Ore Co. v. Union Carbide & Carbon Corp.⁸², the Supreme Court applied the Sherman Act to a vanadium monopoly obtained by the Canadian affiliate of Union Carbide of U.S., because the monopoly was detrimental to an American competitor. The court determined that private parties could attack the anticompetitive conduct of foreign affiliates of American-based multinational corporations through their American parents.

These decisions reflect the conviction that the United States law should apply to foreign corporations owned and controlled by American corporations whenever the conduct of the former causes harm in the United States. This position was rejected in some other cases as a source of conflict with the authority of the host nation to regulate the conduct of domestic companies⁸³.

Cascade Steel Rolling Mills Inc. v. C. Itoh and Co. (America)⁸⁴ involved claims against various Japanese steel manufacturers and their American subsidiary corporations. The court determined that the Japanese parent companies were within its jurisdiction; it held that a

79. C. D. WALLACE, *The Legal Control of Multinational Enterprises*, 1982, p. 178.

80. 148 F.2d 416 (2d Cir. 1945).

81. *Ibid.*, pp. 443-444.

82. 370 U.S. 690 (1962).

83. See D. ARONOFSKY, *op. cit.*, p. 46, fn. 62.

84. 499 F. Supp. 829 (D. Ore. 1980).

subsidiary's activities may be attributed to its parent when the latter sufficiently controls and supervises them. The court developed a test for determining when a foreign parent is susceptible to federal antitrust liability and jurisdiction on the basis of its subsidiary's presence and activities in the United States. The components of the test were: (i) whether the parent and subsidiary have formed a partnership to compete on a worldwide basis; (ii) whether the parent can influence the subsidiary in matters with antitrust consequences; (iii) whether there is an integrated manufacturing, sales and distribution system; and (iv) whether the subsidiary is the parent's marketing arm, with common trademarks and advertising⁸⁵.

In the EEC, the landmark decision in the area is the famous Continental Can case⁸⁶. In 1969, the American Continental Can corporation acquired control of Schmalbach-Lubeca-Werke, a company with the largest market share in the production of metal containers in Germany. In 1970, through its Delaware subsidiary Europemballage Corp., Continental Can acquired a controlling interest in a Dutch company which also had a substantive share in the same market in Benelux.

In its decision, the Commission considered that Continental Can, through its German subsidiary, held a dominant position in the German market, which was a substantial part of the Common Market. It concluded that Continental Can had abused this dominant position (art. 86 of the EEC Treaty) by buying the Dutch company which held a strong position in a neighbouring market. The European Court overruled the Commission's decision on the basis that the Commission failed to establish the existence of a relevant product market but it confirmed the Commission's interpretation that art. 86 is applicable to mergers.

For our purposes, the importance of the decision lies in the fact that the action of the Commission was brought against the American parent as well as against its American subsidiary and not against the German and the Dutch subsidiaries within the Common Market. The Commission based its authority over the American companies on the contention that the American parent corporation, its American subsidiary and its European subsidiaries constituted a single economic entity. Although the merger transaction was effected exclusively by the American subsidiary Europemballage, its parent company was also held responsible because "Europemballage did not display any autonomous behaviour and did not have any economic independence at the relevant time"; "the funds for the acquisition of the shares in Thomassen [the Dutch company] had been available to Europemballage by Continental Can and that, at the

85. *Ibid.*, at 838; see also Copperweld Corporation v. Independence Tube Corporation, 104 S. Ct. 2731 (1984).

86. [1973] 12 C.M.L.R. 199.

date when Continental Can caused Europemballage to make an offer to buy, the latter company was still not fully organized"⁸⁷.

In the case of I.C.I. Ltd. v. E.C. Commission⁸⁸, the concept of the single economic entity was founded upon the controlling power of the parent company, which should, accordingly, be considered responsible for the conduct of its subsidiary. In supporting his opinion, the Advocate General said:

"When the subsidiary does not enjoy any real autonomy in the determination of its course of action on the market, the prohibitions imposed by Article 85(1) may be considered inapplicable in the relations between the subsidiary and the parent company, with which it then forms one economic unit. In view of the unity of the group thus formed, the activities of the subsidiary may, in certain circumstances, be imputed to the parent company."⁸⁹

Similarly, in Commercial Solvents Corp'n. v. Commission⁹⁰, it was held that:

"Where a parent company legally and institutionally controls its foreign subsidiary (in casu by a 51 per cent shareholding, 50 per cent representation on the Board of Directors, and the chairmanship of the board with a casting vote) and in fact favours its subsidiary in supplying an essential raw material (for which it holds a dominant position) which it is withholding from a competitor, then as regards that competitor the parent and subsidiary companies may be regarded as a single economic unit and jointly and severally responsible for the conduct complained of."

The English Fair Trading Act 1973 provides in s. 64(1) that a merger reference may be made to the Monopolies and Mergers Commission by the Secretary of State where it appears to him that two or more enterprises have ceased to be distinct enterprises and that (a) as a result, a specified market share has been achieved or (b) the value of the assets taken over exceeds a specified amount. Any two enterprises will be regarded as ceasing to be distinct enterprises if they are brought under common ownership or common control.

87. *Ibid.*, at 216, 217.

88. *Op. cit.*, under C.

89. *Ibid.*, at 629.

90. *Op. cit.*, under C, at 310.

Among others, two enterprises will come under common control either when they are carried on by two or more corporate bodies over which the same person has control or when the one is carried on by a body corporate and the other is carried on by a person having control over that body corporate⁹¹. Thus, when the merger results in two companies becoming subsidiaries of the same parent company or in one company becoming subsidiary of another, the two companies will cease to be treated as distinct enterprises.

The City Code on Takeovers and Mergers which has been developed since 1959 as an extralegal code of conduct for the regulation of takeovers⁹², requires that, any person, which alone or together with persons acting in concert either acquires shares carrying 30% or more of the voting rights of a company⁹³ or holds not less than 30% but not more than 50% of the voting rights and such person, or any person acting in concert with him, acquires in any twelve months additional shares carrying more than 2% of the voting rights⁹⁴, should extend offers to all shareholders of the class concerned.

For the purposes of the Code, acting in concert means the agreement or the understanding between different persons, specifically to co-operate for the acquisition of shares in a company, by any one of them, in order to obtain or consolidate control of a company. Among others, a company with its parent, subsidiary and associate companies are presumed to be acting in concert. Hence, holdings and acquisitions of parent, subsidiary and associate companies are deemed, for the purposes of the rule, as holdings and acquisitions of a single business entity which acts in a co-ordinated and centrally-controlled manner⁹⁵.

The German Law against Restraints of Competition (GWB, *Gesetz gegen Wettbewerbsbeschränkungen*) provides in s. 23 (1) that if one party to a merger is a member of a group as it is defined in arts. 17 and 18 of the *Aktiengesetz*⁹⁶, whether in a controlling or a controlled capacity, then each member of the group is considered a participant in the merger. Thus, a non-German parent company of a multinational group of companies might be subject to the extraterritorial reach of the German competition laws when one of its subsidiaries is located in Germany. For instance, the Federal Cartel Office (*Bundeskartellamt*) issued an order

91. S. 65.

92. See J.H. FARRAR, N.E. FUREY, B.M. HANNIGAN, *Farrar's Company Law*, 3rd ed., 1991, pp. 613-615.

93. City Code, r 9.1 (a).

94. City Code, r 9.1 (b).

95. For the application of the rule in a case involving acquisitions beyond the threshold of 30% by companies controlled by the same individual, see J.H. FARRAR et al., *op. cit.*, pp. 637-638.

96. See below, ch. VIII, A, i.

restraining temporarily the conclusion of a merger between two Dutch companies because they both had subsidiaries in Germany which were strong competitors in the relevant market. The merger of the parent companies was considered to constitute a merger of the subsidiaries⁹⁷.

In France, under the threat of penal sanctions, every natural or legal person who intends to acquire a number of shares in a company quoted in the Stock Exchange, representing a certain percentage of its share capital, has to inform that company of the number of shares or voting rights already held⁹⁸. For determining the threshold which triggers the obligation to inform, the new texts added by the law of 2 August 1989, include in the calculation of the shares held by the bidder the shares held by companies under his control, as control is defined under s. 355-1 of the law of 24 July 1966⁹⁹. Thus, the shares held by a subsidiary are treated as being held by its parent.

To a certain extent, therefore, decisions and provisions in the area of Competition law recognize that parent and subsidiary tend to act as one economic unit. The conduct of the subsidiary may be imputed to the parent in cases where the parent actually controls or it is deemed to control the relevant operations of the subsidiary.

E: LABOUR LAW

For Labour Law, groups of companies present the problem of adequate representation of the employees' interests in the decision-making procedure. On the EC as well as on the national level, there are regulations on worker's representation on board level in groups of companies which proceed on the assumption that issues of major importance for the subsidiary are decided by the board of the parent.

In 1973, the EC Commission presented a Communication to the Council on Multinational Undertakings and Community Regulations. The Commission pointed out that:

"[It is] aware of the legal problem raised by the need for appropriate representation of employees' interests vis-a-vis a company which no longer takes its decisions independently but complies with those of the group of which

97. Decision of May 3, 1978 (*Kartoffelstärke*), Bundeskartellamt, [1978] WuW/E 598 BKartA 1716, quoted in C.D. WALLACE, *op. cit.*, p. 217; for another similar case, see K. MARKERT, *Recent Developments in German Antitrust Law*, 43 *Fordham Law Review*, 1975, p. 697 at 715.

98. *L. 1966, art. 356-1 nouveaux*.

99. See below, ch. VIII, B, i.

it forms part. In the course of the coordination of the law on groups of companies which it is at present undertaking, the Commission will examine the question as to what measures will have to be adopted in this field. The provision of information for, and the participation of employees in cases where either the parent company or any of the member undertakings of the group are situated outside the Community, raise substantial problems to which the Commission's departments are seeking adequate solutions"¹⁰⁰.

Accordingly, the Commission included rules for employees' information and participation in groups of companies in two proposals, the initial proposal for a European Company Statute which was submitted to the Council in 1970¹⁰¹ and amended in 1975¹⁰² and the so-called Vredeling draft Directive on procedures for informing and consulting employees, initially proposed in 1980¹⁰³ and amended in 1983¹⁰⁴. Although both proposals have, in fact, been abandoned¹⁰⁵, they are highly important for our purposes since they inherently accept that the real decision-making centre for major decisions concerning the subsidiaries' workers is not the subsidiary's board but the board of the company at the top of the group.

The draft Statute for European Companies of 1970/1975¹⁰⁶ contained a number of provisions applicable to the situation where a European company was the dependent or the controlling enterprise of the group. For instance, employees of all group companies whose registered offices were situated within the EEC and which were dependent on the SE, were entitled to take part in elections for the supervisory board of the SE (art.137). If an SE was a controlling group company, a Group Work's Council had to be formed (art.130) in which the employees of all group companies were represented (art.131).

100. EC-Bulletin, Supplement 15/73, p. 11.

101. OJCE 1970 C 129, Supp. to EC Bulletin 8/70.

102. Supp. 4/75 to EC Bulletin.

103. OJCE 1980 C 297, p. 3.

104. OJ 1983 C 217, p. 3.

105. As regards the so-called Vredeling draft Directive, the Council adopted on 21 July 1986 formal conclusions suspending its examination of the Commission's amended proposal (OJEC 1986 C 203 p.1); the European Company draft Statute was replaced in 1989 by formal proposals to the Council for a Regulation on a Statute for a European Company (COM 89 268 final, OJ C 263 p.41) and a complementary Directive regarding the involvement of employees in the European Company (COM 89 268, OJ C 263 p.69) which is of no relevance for groups of companies; the same applies to the revised proposal which the Commission submitted to the Council in May 1991 (COM(91) 174 final OJ C176 8.7.91 p.1).

106. Also discussed in ch. VIII, C, ii.

The draft "Vredeling" Directive deals with the issue of labour relations within groups of companies more comprehensively. It is significant that, for the purposes of the draft Directive, a group of companies is treated in the same way as a single undertaking operating through branches located in geographically distinct areas. Thus, the Directive purports to apply not only to groups of undertakings (parent undertakings and subsidiaries) but to any single undertaking operating through such branches and employing in total at least 1000 workers in the Community (art. 2). The concepts of parent undertaking and subsidiary are defined by reference to the criteria adopted by the Council in the Seventh Directive on company law¹⁰⁷.

The information procedure of the amended proposal of 1983 requires the management of a parent undertaking to forward general information about the activities of the parent undertaking and its subsidiaries, as a whole, to the management of the subsidiaries established within the Community (art. 3, par. 1). The information to be forwarded includes details of the group structure, the economic and financial situation, the probable development of business, production and sales, the employment situation and probable trends as well as investment prospects (art. 3, par. 2). The management of each subsidiary has then to disclose and if necessary to comment on this information to the employees' representatives within the subsidiary according to the laws and practices of the Member States in which it is established (art. 3, par. 4).

Where the management of the subsidiary fails to fulfil its disclosure obligations, the representatives of the employees may approach in writing the management of the parent undertaking, who will then be obliged to communicate the relevant information without delay to the management of the subsidiary for submission to the employees (art. 3, par. 5).

The consultation procedure provided for in the proposal has to be followed when the management of the parent undertaking proposes to take a decision "concerning the whole or a major part of the parent undertaking or of a subsidiary in the Community, which is liable to have serious consequences for the interests of the employees of its subsidiaries in the Community" (art. 4, par. 1). Such decisions may in particular relate to the closure of establishments, to substantial modifications of the undertaking's activities, to major modifications affecting the undertaking's internal organization, to working practices and production methods, to cooperation with other undertakings, or to measures relating to workers' health and to industrial safety (art. 4, par. 2).

107. Council Directive (EEC) 83/349 on Consolidated Accounts (OJ. L. 193, 18.7.83, p.1), art. 1; see below, ch. VII, A, i.

The management of the parent undertaking must forward to the management of each subsidiary concerned, precise information indicating the grounds for the proposed decision, its consequences for the employees concerned and the measures planned in respect of such employees (art. 4, par. 1). The management of each subsidiary concerned must without delay communicate the information received to the employees' representatives and ask for their opinion on the proposed decisions (art. 4, par. 3). The proposed decision cannot be implemented before the opinion of the employees' representatives is received or, failing that, before the end of the period granted for delivering that opinion, i.e. at least 30 days (art. 4, par. 5).

The management of the parent or the subsidiary undertaking is free to disregard the employees' opinion and, additionally, is free to refrain from disclosing any information which is regarded to be of a secret character (art. 3 par. 4, art. 4 par. 3, art. 7 par. 1). However, the draft requires Member States to ensure the right of employees' representatives to appeal to a tribunal or administrative authority in order to compel the management of the subsidiary to fulfil its obligations (art. 4, par. 4) as well as in order to settle disputes concerning the secret character of any information which was withheld (art. 7, par. 3).

On the national level, there are provisions which purport to ensure that the interests of a subsidiary's employees are adequately represented in the managerial bodies of the parent. For instance, the German Codetermination Law of 1976¹⁰⁸ provides for the representation of all employees of the group, whether they are employed by the parent company or by a subsidiary, on the supervisory board of the principal parent company. There are also provisions for the establishment of central works councils and group works councils composed of representatives of each subordinate works council¹⁰⁹.

The French case law on labour relations aims to ensure the adequate representation of the employees of a group which is artificially divided into separate companies employing a number of employees below the statutory minimum so as to avoid the constitution of a *comité d'entreprise*. Thus, the different companies of a group are considered as forming a unitary enterprise when they constitute one economic and social unit characterized by its centralization

108. *Mitbestimmungsgesetz*, §. 5.

109. Works Constitution Act 1972 (*Betriebsverfassungsgesetz*), ss. 47-59. This Act provides for a system of employees' participation in works councils which is different from the system of participation in the supervisory board. Any kind of establishments and not only companies are obliged to establish and consult a works council. An establishment for this purpose is defined as any unit of activity which "is situated at a considerable distance from the principal establishment" or which "is independent by reason of its function and organization" (§.4).

of direction and the complementary character of its activities¹¹⁰. In this case, employees of the different companies of the group are allowed to be represented in representative bodies which are common to all the companies of the group (a single enterprise committee, a single trade union delegation, or common staff delegates)¹¹¹.

The idea of the group as one economic and social unit has been adopted by the legislature by virtue of the law of 28 October 1982 which provides for the constitution of group committees (*comités d'entreprise du groupe*). Group committees have to be established in groups formed by a dominant company and companies placed under its control¹¹²; they should be consulted on the economic and legal organization of the group, and especially in the cases of mergers, acquisitions or closures of subsidiaries¹¹³.

In Britain, the Bullock Committee, in making its recommendations for the development of industrial democracy, considered the problem of employee representation on the boards of operating subsidiaries within large groups of companies but it did not recommend the representation of the interests of the subsidiaries' employees on the board of the parent¹¹⁴.

In general, however, it can be concluded that labour law adopts a realistic approach towards groups of companies. The regulations on worker's representation proceed on the idea that the crucial decisions for the subsidiaries' employees are taken by the parent company. As the group follows a uniform policy in order to achieve centrally determined targets, it is considered necessary to allow employees representation in or consultation with the centre where actually the policy is formulated and the targets are set, i.e. the parent company.

F: CONCLUSION

There are some fields of law which, to a certain extent, have recognized and gave effect to the reality of the group and especially to the linkage of managerial control between parent and subsidiary companies.

110. Cass. soc., 19 december 1972, D. 1973, 382, note Despax, Rev. Soc., 1973, 513, note Oppetit.

111. See P. RODIERE, Group Enterprises in French Labour Law, in D. SUGARMAN & G. TEUBNER (ed.), *Regulating Corporate Groups in Europe*, 1990, p. 305 at 306-307; Y. GUYON, *Droit des Affaires*, t. 1, 6e ed., 1990, para. 622, p. 622.

112. C. trav., art. L. 439-1.

113. See G. RIPERT, R. ROBLOT, *Traité Elementaire du Droit Commercial*, 14th ed., t. 1, 1991, para. 714(1), p. 591.

114. Cmnd. 6706, 1977, p. 129; see T. HADDEN, *op. cit.*, p. 41.

For accountancy and taxation purposes, group accounts and anti-transfer-pricing measures, respectively, constitute significant signs of legislative distrust for the legal, but mainly for the economic independence of the component units of the group. Both kinds of measures are based on the assumption that the group constitutes a single unit and that subsidiary companies are typically managed by their parent in the interests of the group as a whole.

Private International Law, for personal jurisdiction purposes, typically subjects every company to the jurisdiction of its place of incorporation or to the jurisdiction of the place where control is exercised. The exercise of central management by the parent over its subsidiary is often taken into account in order to treat the group as a single entity and to subject the parent to the jurisdiction of the subsidiary and vice versa.

In Competition and Antitrust Laws, the anticompetitive conduct of a subsidiary company which is closely controlled by its parent is often imputed to the latter. Also, for the purposes of some notification procedures, the shares held or acquired by different companies of the same group are deemed as being held or acquired by one single entity which is presumed to act in a co-ordinated manner.

In Labour Law, there are regulations which assume that the real decision-making authority in respect of matters crucial for employees of a subsidiary lies with the board of the parent company. Accordingly, employees of a subsidiary are allowed to be represented in the parent's board as well as to be informed and consulted about issues of great importance for the subsidiary and the group as a whole.

Hence, there is a tendency in some areas of law to disregard the legal separation of the group into parent and subsidiary companies. There is a widespread conviction that the group of companies should be treated as a single unit where the respect to the legal formalities might lead to an unreasonable result: in the field of accounting, it might lead to the provision of misleading information to interested parties; in the field of taxation, it might lead to tax avoidance; in Private International Law, it might lead to avoidance of jurisdiction; in Competition Law, it might lead to evasion of market regulations; finally, in Labour Law, it might lead to the deprivation of the employees' rights to information and consultation.

The group is treated as a single unit on the evidence or on the assumption that the parent company is in managerial control of its subsidiaries. The element of the managerial control of the parent turns the subsidiary into a mere department of the group notwithstanding that it constitutes a separate legal person.

CHAPTER VI: GROUPS OF COMPANIES IN UK CASE LAW

In company law, unlike other legal areas, there is a considerable tension between legal regulation and actual practice: in practice, the typical group operates as a single enterprise under the auspices and the direction of the parent company; in the eyes of company law, however, parent and subsidiary are considered separate entities with independent managerial teams and distinct business objectives.

This is due to the fact that company law is largely based on the concept of the independent entity of the company with separate legal personality and regulates all the issues it deals with on the basis of this concept. As a consequence, every company is liable for its own obligations, and the parent company is, in principle, liable for the debts of its subsidiary only to the extent of its subscription to the subsidiary's capital.

In English company law, in particular, the strict adherence to the rule of limited liability even in situations where the parent is extensively involved in the management of its subsidiary is largely due to the predominance of the Salomon doctrine.

A: THE SALOMON DOCTRINE

The Salomon doctrine was first enunciated by the House of Lords in the famous Salomon v Salomon¹ case which reversed the decision of the Court of Appeal². It was a case of a sole trader, Aron Salomon, who sold his solvent business to a limited company consisting of the minimum number of members: himself, his wife, his daughter and his four sons. Of the 20,007 shares of the company, 20,001 were allotted to Aron Salomon and one share to each other

1. Salomon v. Salomon & Co., H. L. 1897, [1897] A.C. 22; L.J. Ch. 35.

2. Broderip v. Salomon, Ch. D. and C.A. 1895, 2 Ch. 323.

member. As part of the payment by the company formed, debentures forming a floating charge were issued to Salomon who was also appointed managing director of the company.

As the business did not prosper, the company was wound up, and, after satisfying the debentures, there was not enough to pay the ordinary creditors. The liquidator, representing the unsecured trade creditors of the company, claimed that Aron Salomon should not be protected by limited liability and he should be ordered to indemnify the company against the amount by which its assets were found in the winding-up to be insufficient for the payment of its debts. He also claimed that payment of the debenture debt to Salomon should be postponed until the company's other creditors were satisfied. The reasoning was that the company was not a genuine association of seven members but a mere sham designed to limit the liability which Salomon would incur in case the business was not incorporated.

In the Court of first instance where the claim of the liquidator was upheld, Vaughan Williams J. considered the relationship between Salomon and the company as one between principal and agent:

"[T]his business was Mr Salomon's business and no one else's.; ... he chose to employ as agent a limited company; ... he is bound to indemnify that agent, the company. The creditors of the company could, in my opinion, have sued Mr Salomon. Their right to do so depends on the circumstances of the case, whether the company was a mere alias of the founder or not. In this case it is clear that the relationship of principal and agent existed between Mr. Salomon and the company."³

In the Court of Appeal the same result was reached, although through a different line of argument. In rejecting the agency inference, Lindley L.J. pointed out:

"As the company must be recognized as a corporation, I feel a difficulty in saying that the company did not carry on business as a principal, and that the debts and liabilities contracted in its name are not enforceable against it in its corporate capacity."⁴

In giving his own reasons for imposing liability on Salomon, the same judge said:

"There can be no doubt that in this case an attempt has been made to use the machinery of the Companies Act, 1862, for a purpose for which it never was

3. *Id.* at 331-332.

4. *Id.* at 338.

intended. The legislature contemplated the encouragement of trade by enabling a comparatively small number of persons - namely, not less than seven - to carry on business with a limited joint stock or capital, and without the risk of liability beyond the loss of such joint stock or capital."⁵

.....

"If the legislature thinks it right to extend the principle of limited liability to sole traders it will no doubt do so, with such safeguards, if any, as it may think necessary. But until the law is changed such attempts as these ought to be defeated whenever they are brought to light. They do infinite mischief; they bring into disrepute one of the most useful statutes of modern times, by perverting its legitimate use, and by making it an instrument for cheating honest creditors."⁶

The appeal of Aron Salomon was, therefore, dismissed on the ground that "the formation of the company ... and the issue of debentures to Aron Salomon ... were a mere scheme to enable him to carry on business in the name of the company with limited liability, contrary to the true intent and meaning of the companies Act, 1862, and, further, to enable him to obtain a preference over other creditors of the company by procuring a first charge on the assets of the company by means of such debentures⁷.

It was thus considered that protecting Salomon with limited liability was contrary to the true intent of the statutes introducing the rule of limited liability. The Court of Appeal, in conformity with the origins of limited liability, raised the point that the rule was never intended to protect a person who is, virtually, the sole owner of the company and, in addition, manages its business according to his personal interests and contrary to the interests of the company's creditors. The rejection of this argument and the resulting reversal of the decision in the House of Lords constitutes the reason for which Salomon v. Salomon is considered a turning point in the history of English company law.

5. *Ibid.*, at 337.

6. *Ibid.*, at 339.

7. *Ibid.*, at 340.

Corporate personality and limited liability

The decision of the House of Lords is considered to have established the separate legal personality of the company. As Lord Denning pointed out, the doctrine laid down in Salomon v. Salomon "has often been supposed to cast a veil over the personality of a limited company through which the courts cannot see"⁸.

The concept of the separate corporate personality has been clearly laid down in the dictum of Lord Macnaghten:

"The company is at law a different person altogether from the subscribers to the memorandum; and though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them."⁹

Insofar as one construes Salomon as a case which merely lays down the concept of the separate legal personality of the company, in the lines put forward by Lord Macnaghten, the case does not seem to have brought about any radical innovation. It simply restates in an authoritative manner the well founded principle that an incorporated company cannot be identified with its members but it has a personality of its own. This principle had been established much earlier than the Salomon decision at the time when charters and incorporating Acts started to allow groups of individuals to carry on commercial activities as joint stock associations with separate personality¹⁰.

However, Salomon's predominant place in English company law is not merely due to the establishment of the corporate personality concept. Lord Macnaghten did not simply state that the company has a personality of its own, distinct from the personality of its subscribers. He went on to make a more radical proposition: "Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act."¹¹

Thus, in the opinion of the House of Lords, the rule of limited liability is firmly bound up with the concept of corporate personality. Whenever an association of natural persons is deemed to

8. Littlewoods Mail Order Stores Ltd. v. IRC, [1969] 3 All E.R., 855 at 860, discussed below, in C, i, a.

9. Salomon v Salomon & Co., op. cit., 51.

10. See *supra*, ch. I, A.

11. Salomon v. Salomon & Co., op. cit., 51.

constitute a separate legal person, its members should not, as such, be liable for the association's debts.

For the subsequent development of English company law, the net effect of this proposition was the close association between a theoretical concept i.e. the corporate personality and a legal rule i.e. the limited liability, which was originally introduced merely as a result of social and economic considerations.

The rigidity of this association became evident in a very recent case where the issue of the members' liability was in question. In the case of J. H. Rayner (Mincing Lane) Ltd. and Others v. Departments of Trade and Industry and Others¹², concerning an action for recovery of a debt incurred by an international organization (International Tin Council) on which the status and the legal capacities of a corporate body were conferred, Staughton J., in the Court of first instance, concluded:

"If by English legislation the I.T.C. had been made a corporation, or body corporate, or a separate legal person in those very words, its members would have had no direct liability for the obligations of the I.T.C. unless the legislature had said so in express terms. Otherwise, separate legal personality is, in English law, inconsistent with the members of an association being liable for its debts."¹³

The same argument was put forward in the Court of Appeal by Kerr L.J.:

"The interposition of a legal entity between an unincorporated group of persons on the one hand, and third parties who enter into the contracts with the legal entity on the other, has the consequence under the common law that the members of the group have no liability for the contracts made by the entity, unless these were made on their behalf pursuant to the doctrine of agency."¹⁴

Thus, by virtue of the predominance of the Salomon doctrine in modern English company law, limited liability has been elevated to the status of a legal postulate alongside the concept of corporate personality. The application of limited liability ceased to be the result of socio-economic considerations, as it was in the early limited liability statutes, but it is automatically applied whenever a business takes the form of an incorporated company.

12. [1987] B.C.L.C. 667.

13. Ibid., at 692.

14. [1988] 3 W.L.R. 1033, at 1087.

B: THE SALOMON DOCTRINE AS APPLIED IN GROUPS

The total departure from socio-economic considerations as a result of the Salomon decision, explains, to a great extent, why limited liability is invariably applied in the parent-subsidary context. Although in the typical group parent and subsidiary constitute parts of the same economic entity, and the parent is both the principal shareholder and the actual manager of the subsidiary, the former cannot be held liable for the debts of the latter simply because they constitute two separate legal entities.

There are two recent cases where the Salomon doctrine was applied in the context of groups of companies. In these cases, the courts were asked to give effect to the economic reality and to ignore the legal separation between parent and subsidiary companies, essentially in order to impose liability on the leading company of the group for liabilities incurred by one of its subsidiaries. Although in both cases it was evidenced that the leading company of the group exercised a substantial degree of managerial control over the subsidiary, the courts, relying on the Salomon doctrine, regarded this as a matter without legal significance.

i) The Cape Industries case

The most recent is the case of Adams and Others v. Cape Industries plc. and another¹⁵. This case concerned an action for damages brought in the United States against an American company and its English parent. As the English parent took no part in the proceedings before the American court, the plaintiffs brought proceedings against it in England, in order to enforce the judgement of the American court imposing liability, under the common law rule that a judgement in personam of a foreign court of competent jurisdiction could be sued on in England as creating a debt between the parties.

The plaintiffs contended that the American court was a court of competent jurisdiction because the English parent company, as the judgement debtor, had been resident in the United States by virtue of being present and carrying on business in the United States through its United States subsidiary.

15. [1991] 1 All E.R. 929.

In the evidence it was found that NAAC, the subsidiary, was until 1975 wholly-owned by Cape, the defendant parent, and, after 1975, was wholly owned by CIOL, a wholly-owned subsidiary of Cape. NAAC's dominant purpose was to assist and encourage sales in the United States of asbestos mined by the other Cape subsidiaries¹⁶. Senior officers of the parent were sitting in the board of the subsidiary¹⁷.

It was also found that the corporate activities of the subsidiary were closely controlled by the parent. The parent directed the level of the dividend and the level of permitted borrowing. Such corporate financial control was considered to be "no more and no less than was to be expected in a group of companies such as the Cape group"¹⁸. Also, the senior management of Cape were very anxious that the Cape's connections with AMC, the subsidiary which substituted NAAC after the latter's liquidation, should not become publicly known; some of the letters and memoranda had a "conspirational flavour" in them¹⁹.

In the light of this evidence, it was concluded that the main purpose behind the creation of the subsidiary in the United States was for the English parent to avoid being subject to liability and jurisdiction. Slade L.J. unreservedly pointed out the following:

"The inference which we draw from all the evidence was that Cape's [the parent's] intention was to enable sales of asbestos from the South African subsidiaries to continue to be made in the United States while (a) reducing the appearance of any involvement therein of Cape or its subsidiaries, and (b) reducing by any lawful means available to it the risk of any subsidiary or of Cape as parent company being held liable for United States taxation or subject to the jurisdiction of the United States courts, whether state or federal, and the risk of any default judgement by such a court being held to be enforceable in this country"²⁰.

This conclusion being reached, one would have expected the court to give effect to the dependence of the subsidiary on its parent, and accordingly, to consider that the parent company was present and was carrying on business in the United States through its American subsidiary. Nevertheless, in the Court of first instance, it was held that the presence in Illinois of the

16. *Ibid.*, at 993.

17. *Ibid.*, at 995.

18. *Ibid.*

19. *Ibid.*, at 996.

20. *Ibid.*, at 1024.

defendant's subsidiary could not be treated for jurisdictional purposes as the presence of the defendants themselves. The plaintiffs appealed against this decision. The appeal was dismissed, among others, for the following reason:

"In particular, the defendants and the subsidiary ... could not be treated as a single economic unit and although the setting up of the subsidiary and the marketing arrangements made with the subsidiary ... were a facade to enable the defendants to continue to sell asbestos in the United States while reducing the appearance of the defendants being involved in such sales and reducing by lawful means the defendant's risk of liability to taxation in the United States or of being made subject to the jurisdiction of the United States courts, there was nothing illegal in the defendants using their corporate structure to ensure that future legal liabilities to third parties would fall on another member on the group rather than on the defendants, and in those circumstances the court would not lift the corporate veil so that the presence of the subsidiary could be treated as the presence of the defendants."²¹

It was further concluded that:

"Whether or not this is desirable, the right to use a corporate structure in this manner is inherent in our corporate law ... Cape [the parent] was in law entitled to organize the group's affairs in that manner and to expect that the court would apply the principle of *Salomon v. Salomon* in the ordinary way"²².

Hence, the court ignored the subsidiary's heavy dependence on its parent and adhered strictly to the *Salomon* doctrine. Although the subsidiary was a mere tool of operation for the parent company, its separate corporate personality enabled the parent to avoid any sort of responsibility for its operations.

However, it is the *Salomon* doctrine itself, which, if carefully followed, would have led to an opposite decision in the *Cape Industries* case. In the *Salomon* case, although it was pointed out that among the principal legitimate reasons for creating a company is the limitation of the members' liability²³, the decision was in favour of *Salomon* because he was "not shewn to

21. *Ibid.*, at 931.

22. *Ibid.* at 1026.

23. *Salomon v. Salomon*, *op. cit.*, at 42, 52.

have done or to have intended to do anything dishonest or unworthy"²⁴. On the contrary, in the Cape Industries case the Salomon doctrine was upheld although it was accepted that there was, if not a fraudulent, at least a dishonest use of the subsidiary; the subsidiary was considered to be a mere facade²⁵ used merely for the concealment of the real situation and for the avoidance of liability and jurisdiction.

The approach taken in Cape Industries was not applied in the recent case of Creasey v. Breachwood Motors Ltd.²⁶, where a company with a contingent liability to the plaintiff became insolvent and transferred its assets to another company with the same shareholders and directors. The court held that it would be justified in lifting the veil and treating the second company as liable for the obligation of the first on the ground that the transfer of assets from the one company to the other would otherwise enable the group as a whole to evade responsibility for the plaintiff's claim²⁷.

In earlier cases concerning the application of the Salomon doctrine in the traditional context of the single, independent company, it was clearly stated that Salomon has no place where the company is used as a means of concealing the existing reality. Typical are the statements of Ormerod L.J. in the case of Tunstall v. Steigman²⁸ that "... any departure [from the Salomon principle] ... has been made to deal with special circumstances when a limited company might well be a facade concealing the real facts" and of Lord Keith in the case of Woolfson v. Strathclyde Regional Council²⁹ that "it is appropriate to pierce the corporate veil only where special circumstances exist indicating that it is a mere facade concealing the true facts".

Special circumstances were found to exist in Gilford Motor Company Limited v. Horne³⁰. In that case, Horne, the defendant, as a former employee of the plaintiffs had covenanted not to solicit its customers. When he attempted to breach this obligation by forming a company, the plaintiffs asked for an injunction to prevent him and the company from soliciting the plaintiffs' customers. Notwithstanding that, in law, the defendant company was a separate entity from the

24. *Ibid.*, at 34; see also at 52-53, where Lord Macnaghten is careful to stress that Salomon had not acted fraudulently or dishonestly.

25. Adams and others v. Cape Industries plc. and another, *op. cit.*, at 931.

26. [1992] B.C.C. 638.

27. *Ibid.*, at 647-648 per Richard Southwell Q.C.; see also Re a Company, [1985] B.C.L.C. 333.

28. [1962] 2 Q.B. 593, at 602.

29. [1978] S.L.T. 159 at 161.

30. [1933] Ch 935.

defendant Horne, an injunction was granted against both him and the company, although the company was not a party to the covenant.

The Court of Appeal relied upon evidence that the "boss" and the "guvnor" of the defendant company was Horne himself and that the "defendant company was the channel through which the defendant Horne was carrying on his business"; the defendant company "was formed as a device, a stratagem, in order to mask the effective carrying on of a business of Mr E.B. Horne ... [t]he purpose of it was to try to enable him, under what is a cloak or sham, to engage in a business ... in respect of which he had a fear that the plaintiffs might intervene and object"³¹.

Also, in Jones v. Lipman³², a case where the defendant attempted to evade his obligation to sell his house to the plaintiff by transferring it to a company created for this purpose, the court ordered both the defendant and his company specifically to perform the agreement, although the company was not a party to it. The court relied upon evidence suggesting that "the defendant company was, and at all material times had been, under the complete control of the defendant"; "the defendant company is the creature of the first defendant, a device and a sham, a mask which he holds before his face in an attempt to avoid recognition by the eye of equity"³³.

Although the above decisions have not clarified the term "facade" or the equivalent terms used, they relied heavily on the fact that the corporator had complete control over the company³⁴. Helpful is the definition of "facade" given by Rixon, who, consulting the Concise Oxford Dictionary, explains the term as denoting outward appearance, especially one that is false or deceptive and importing pretence and concealment; in the particular context of lifting the veil, he specifies it as the deliberate concealment of the identity and the activities of the corporator³⁵.

In view of the facts and the existing authorities, it is surprising that the Court of Appeal in the Cape Industries case upheld the Salomon doctrine in circumstances which clearly and explicitly fall beyond the ambit of its application. Like the individual defendants in Guilford Motor v. Horne and in Jones v. Lipman, the parent company in the Cape Industries case attempted to avoid the imposition of legal consequences by creating a limited company over which it

31. *Ibid.*, at 969.

32. [1962] 1 W.L.R. 832.

33. *Ibid.*, at 836.

34. However, in Tunstall v. Steigman (op. cit., at 602), it was argued that complete control of the company is not enough to constitute the company a mere facade.

35. F.G. RIXON, *Lifting the Veil between Holding and Subsidiary Companies*, 102 L.Q.R. 1986, p. 415, at 423.

exercised a substantial degree of managerial control. Unlike the other two decisions, however, the decision in *Cape* strictly adhered to the legal separation between the company and its members.

In this particular sense, it can be argued that the *Cape Industries* case has overstepped *Salomon* in its rigidity. It is hoped that it will not constitute, in the context of groups of companies, an "unyielding rock"³⁶ as the *Salomon* case has in the context of the single, independent company.

ii) The Multinational case

The *Salomon* doctrine was also upheld in another case involving a group of companies, in *Multinational Gas and Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd. and others*³⁷. This case involved three large multinational oil companies, incorporated in the United States of America, France and Japan respectively, which formed the plaintiff company in order to carry out a joint venture. The company was registered in Liberia. All of its business was done outside the U.K. and all the directors resided outside the U.K. The three oil companies also formed a U.K. company to act as the plaintiff's agent and adviser.

After six years of trading, the plaintiff found itself into financial difficulties and in 1978 it was wound up bringing a financial disaster for its creditors. The three oil companies did not offer to discharge the plaintiff's liabilities. Because of the disaster, the advising company also fell into difficulties and went into liquidation. The plaintiff, at the instance of its liquidator, sued its directors, the advising company and the three oil companies claiming damages for breaches of duty of care, alleging that the advising company's directors were negligent in the performance of their duties and that its own directors and the three oil companies were also negligent in failing to appreciate the deficiencies in the services provided by the advising company.

Because the only defendants who were in a position to satisfy a monetary judgement were the three oil companies, the claim was structured so as to reach the oil companies and to make them discharge some, at least, of the plaintiff's liabilities. Thus, although the *Multinational* case seemed to involve a technical issue, there was a more substantial issue at stake: the liability of the three oil companies for the obligations of their creature.

36. LORD TEMPLETON, [1990], 11 Co. Law., p. 10.

37. [1983] 2 All E.R. 563.

The difficulty was that the three oil companies were resident abroad prohibiting service of a writ against them unless it could be proved, *inter alia*, that they were, according to R.S.C., Ord. 11, R.1(1)(j), necessary or proper parties to the action brought within the jurisdiction against the advising company. The court was asked to decide whether the three companies had a good defence in law against the action of the plaintiff for breach of their duties. In case they had such defence, the court could not permit service out of the jurisdiction.

The three oil companies were the sole shareholders in both the advising company and the plaintiff. They appointed the directors of the companies as their employees and nominees with the intent that they should run the two companies for and in the interests of the three oil companies³⁸. The statement of claim read as follows:

"... the business and affairs of Multinational [the plaintiff] were, at all material times to this action, under the control of the joint venturers. Further the Multinational Directors acted at all material times in all relevant matters in accordance with the directions and at the behest of the joint venturers; and, accordingly, the powers of directing and managing the affairs of Multinational in relation to the matters hereinafter complained of were vested in and were exercised by the joint venturers. In the alternative, such powers were vested in and exercised by the Multinational Directors as the employees and nominees of the joint venturers and the joint venturers are liable to answer for the acts or defaults of Multinational Directors in the direction and management of the affairs of Multinational."³⁹

Notwithstanding that these allegations were not disputed, the Court of Appeal (May L.J. dissenting) considered that the three oil companies had a good defence in law against the plaintiff's claim and, therefore, they were not proper parties to the action:

"By adopting or approving the acts of the directors of the plaintiff company, the three oil companies acting as shareholders in agreement with each other made those acts the acts of the plaintiff company. It followed that the liquidator could not sue the oil companies because as shareholders they owed no duty to the plaintiff company as a separate entity, and he could not sue the nominee directors because the oil companies had effectively made the acts of the directors acts of the plaintiff company itself".⁴⁰

38. *Ibid.*, at 564.

39. *Ibid.*, at 584-585.

40. *Ibid.*, at 566.

In supporting the majority view, Lawton L.J. pointed out:

"The plaintiff, although it had a separate existence from its oil company shareholders, existed for the benefit of those shareholders, who provided they acted *intra vires* and in good faith, could manage the plaintiff's affairs as they wished. If they wanted to take business risks through the plaintiff which no prudent businessman would take they could lawfully do so. Just as an individual can act like a fool provided he keeps within the law so could the plaintiff, but in its case it was for the shareholders to decide whether the plaintiff should act foolishly. As shareholders they owed no duty to those with whom the plaintiff did business. It was for such persons to assess the hazards of doing business with them."⁴¹

He, therefore, concluded that "the plaintiff cannot now complain about what in law were its own acts" and he saw "no grounds for adjudging that the oil companies as shareholders were under a duty of care to the plaintiff"⁴². Likewise, Dillon L.J. pointed out that "[t]he shareholders owe no such duty [of care] to the company ... so long as the company is solvent the shareholders are in substance the company"⁴³.

In effect, the Salomon doctrine was respected. The plaintiff was a separate legal entity and its shareholders had limited liability. They did not owe fiduciary duties to the company and they could not be sued for its debts. Although the three oil companies created the whole scheme, instigated every movement of the plaintiff, appointed its directors and were in absolute control of its operations, the court treated them as having only the status of a shareholder who owes no duty to the company as a separate entity or to its future creditors. It was not even suggested that the three companies might be treated as directors of the plaintiff, who, as Dillon L.J. pointed out, "indeed stand in a fiduciary relationship to the company, as they are appointed to manage the affairs of the company and they owe fiduciary duties to the company"⁴⁴, or as shadow directors, who, in the event of a company's insolvent liquidation may now become liable for wrongful trading⁴⁵.

41. *Ibid.*, at 571.

42. *Ibid.*

43. *Ibid.*, at 585.

44. *Ibid.*, at 585.

45. IA 1986, s. 214; see below, ch. VII, B, iii.

The approach of the Court in the *Multinational* case is indicative of the rigidity of the Salomon doctrine. Lord Wedderburn wondered how poor old Salomon could be expected to cope with the *Multinational* case⁴⁶. Indeed, there is little, if any, relation between the two cases. Dillon L.J., justifying his opinion in the *Multinational* case, referred to an individual trader who owes no duty of care to future creditors and he is free to make stupid, but honest, commercial decisions in the conduct of his own business⁴⁷. But the *Multinational* case is not about a sole trader or an individual like Salomon who decides to incorporate his moderate-size business. It is about a scheme where three major oil companies decided to embark upon a joint venture taking all the necessary precautions in order to minimize their appearance in the venture and to avoid the imposition of any liability for its losses. The joint venture's collapse brought about loss to the creditors to the extent of about £75,416,000 according to the statement of claim⁴⁸. To uphold the Salomon doctrine in such a situation and to ignore the fact that the loss was, virtually, the result of manifestly imprudent management by the three oil companies, seems quite unreasonable.

iii) The two cases viewed as a whole

The *Cape Industries* and the *Multinational* cases present significant similarities:

- (a) The companies on which liability was sought to be imposed were not the immediate parent companies but the leading companies in the groups concerned. In the *Cape Industries* case the defendant owned the subsidiary through another wholly-owned subsidiary, whereas in the *Multinational* case the plaintiff company was not a subsidiary but the vehicle of a joint venture carried on by the defendants.
- (b) The courts were not asked, in the first place, to impose liability on the leading company, but, in fact, this was the real issue at stake. In the *Cape Industries* case, the plaintiffs were tort creditors trying to enforce a judgement against the leading company of the group; in the *Multinational* case, the company itself, through its liquidator tried to reach the assets of its corporate shareholders in order to make them discharge some of its liabilities towards contractual creditors.
- (c) Finally and most importantly, it was not argued that the leading companies were not in charge of the operations from which the liabilities arose; on the contrary, it was readily accepted that the subsidiary companies were under the close managerial control of the leading companies. Nevertheless, the exercise of such control was not given any legal effect. In both

46. LORD WEDDERBURN, *Multinationals and the Antiquities of Company Law*, 47 M.L.R. 1984, p. 87, at 92.

47. *Multinational Gas and Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd. and others*, op. cit., at 585.

48. *Ibid.*, at 568.

cases, the court, upholding the Salomon doctrine, respected the separate personalities of the companies concerned and refrained from imposing liability on the leading companies of the groups involved.

These two cases underline the predominant judicial tendency on the question of the liability of the parent for the debts of its subsidiaries⁴⁹. This tendency is at great variance with the requirements of equity. In the particular cases, the extent of the liabilities involved⁵⁰ and the extent of the involvement of the leading companies in the activities out of which these liabilities arose, were such that the parent companies should not have been allowed to escape responsibility.

Although the subsidiary companies were, from a legal point of view, distinct legal entities, from a business point of view they were operating for the benefit of their shareholders. Their shareholders were not individual investors who merely put their money in the concern and exercised the rights attached to their shares; they were companies themselves, which, instead of taking a business risk themselves, they allocated it to a creature of their own in order to avoid jurisdiction and liability.

Whereas the business activities out of which the liabilities arose were virtually conducted by the parent companies concerned, the resulting losses fell onto the subsidiary companies, and eventually onto their creditors; the parent companies in fact behaved as if they were third parties ignorant of their subsidiaries' activities. In these circumstances, the strict adherence to the Salomon doctrine is greatly unjustified.

49. In *Re Southard & Co.* (discussed below, under ii, a, 2), [1979] 1 W.L.R. 1198, at 1208, Templeman L.J. said (also quoted *supra*, Introduction, A):

"English company law possesses some curious features, which may generate some curious results. A parent company may spawn a number of subsidiary companies, all controlled directly or indirectly by the shareholders of the parent company. If one of the subsidiary companies ... turns out to be the runt of the litter and declines into insolvency to the dismay of its creditors, the parent company and other subsidiary companies may prosper to the joy of the shareholders without any liability for the debts of the insolvent subsidiary."

50. In the *Cape Industries* case, 205 plaintiffs brought actions against the parent claiming an average of \$75,000 each, for damages for injuries, *Adams and others v. Cape Industries plc. and another*, op. cit., at 929; in the *Multinational* case, the liabilities of the plaintiff company towards its contractual creditors were about £75,416,000, *Multinational Gas and Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd. and others*, op. cit., at 568.

C: EXCEPTIONS TO THE DOCTRINE

Unlike the Cape Industries and the Multinational cases, there are cases involving groups of companies where the Salomon doctrine was not strictly followed. In these cases, the legal formalities were ignored and the courts, considering the realities of the situation, treated parent and subsidiary companies within the same group otherwise than independent legal entities.

It is commonly suggested that these cases constitute a distinct category of disregarding the Salomon doctrine; they are considered as cases where the courts have shown a willingness to look upon a group of companies as one economic unit⁵¹ or cases where the subsidiary company was treated as an agent of its parent company and as conducting the latter's business⁵².

A careful consideration of these cases indicates that the courts, whenever they have ignored the legal separation between the parent and the subsidiary, did so on the basis of the managerial control exercised by the parent. The description of the subsidiary as an agent of the parent or of the whole group as one economic unit or a partnership of companies was merely used in order to indicate the subsidiary's subjection to the parent's managerial control.

In very few of these cases the exercise of managerial control by the parent resulted in the abrogation of the limited liability of the parent. For our purposes, the importance of these cases lies mainly in the factual criteria upon which the courts were ready to give legal effect to the exercise of managerial control by the parent. Whether the same criteria can be used in order to establish managerial control by the parent for liability purposes, is a question that remains to be answered.

i) The subsidiary as an agent of the parent

In the Salomon case, the court was asked to infer that the company was the agent of its sole owner, who, as a result, should be made liable for its debts. In the Court of first instance, such an inference was drawn on the basis that the company was actually carrying on the business of its controlling shareholder⁵³. On the contrary, in the House of Lords, it was held that the company, as an altogether different person at law from its subscribers, cannot be their agent⁵⁴.

51. See J.H. FARRAR, N.E. FUREY, B.M. HANNIGAN, *Farrar's Company Law*, 3rd ed., 1991, p. 76.

52. L.C.B. GOWER, *Gower's Principles of Modern Company Law*, 4th ed., 1979, p. 129. In the 5th ed. (1992), a different classification was followed; see pp. 124-134.

53. *Broderip v. Salomon*, op. cit., at 331.

54. *Salomon v. Salomon*, op. cit., at 31, 43, 51.

However, in subsequent cases concerning parent and subsidiary companies, it was held that the subsidiary company was acting as an agent for its parent when it was found that the parent company exercised a substantial degree of managerial control.

a. The cases

In the case of Roberta⁵⁵, the parent company was held liable on a bill of lading signed on behalf of its subsidiary, because the subsidiary was actually carrying on the business of the parent in another country. The case concerned a damages claim by various owners of cargo against the owners of the vessel and against the time charterers. The alleged liability of the charterers was founded upon nine bills of lading signed on behalf of their subsidiary. In view of the evidence that the charterers owned all the issued shares of the subsidiary, supplied two out of its three directors and treated its profits as their own⁵⁶, it was accepted that "the Dordtsche Company [the subsidiary] are a separate entity from Walford Lines Ltd.[the parent], in name alone, and probably for the purposes of taxation". As a result, "all controversy as to responsibility for the bills of lading virtually ceased"⁵⁷ and the contract upon the bills of lading was deemed to be a contract for which the parent company was responsible.

In Smith, Stone & Knight v. Birmingham Corporation⁵⁸, the subsidiary was described as the "agent or employee or tool or simulacrum" of the parent company because it was carrying on its business on behalf of the parent.

In that case, the plaintiffs acquired a partnership business and created a subsidiary to carry it. The City of Birmingham acquired by expropriation the premises upon which the business of the subsidiary was conducted. The plaintiffs claimed that they were the proper parties to claim compensation for disturbance of the business which was carried on these premises. If the claim was made by the subsidiary company, the defendants would have been able to avoid paying compensation altogether.

The plaintiffs succeeded in their claim. The court relied on the following findings:

"It was a company [the subsidiary] with a subscribed capital of £502, the claimants [the parent company] holding 497 shares. They found all the money,

55. [1937] 58 Ll.L.Rep. 159.

56. *Ibid.*, at 166-167, 169.

57. *Ibid.*, at 169.

58. [1939] 4 All. E.R. 116.

and they had 497 shares registered in their own name, the other five being registered one in the name of each of the five directors. There were five directors of the Waste company [the subsidiary], and they all executed a declaration of trust for the share which they held, stating that they held them in trust for the claimants ... The new company purported to carry on the Waste business in this sense, that their name was placed upon the premises, and on the note paper, invoices etc. It was an apparent carrying on by the Waste Company ... The books and accounts were all kept by the claimants; the Waste company had no books at all ... There is no doubt that the claimants had complete control of the operations of the Waste company ... There was no tenancy agreement of any sort with the company; they were just there in name. No rent was paid. Apart from the name, it was really as if the manager was managing a department of the company."⁵⁹

In the light of these circumstances, Atkinson J. refused to uphold the Salomon doctrine and to give effect to the separate legal personality of the subsidiary, although the subsidiary was in apparent occupation of the premises and was carrying on the business on its own name. Instead, Atkinson J. considered:

"[I]f ever one company can be said to be the agent or employee, or tool or simulacrum of another ... the Waste company was in this case a legal entity, because that is all it was. There was nothing to prevent the claimants at any moment saying: "We will carry on this business in our own name". They had but to paint out the Waste company's name on the premises, change their business paper and form, and the thing would have been done ... the business belonged to the claimants; they were ... the real occupiers of the premises."⁶⁰

Atkinson J. went further than merely adjudicating on the issue before him. After considering a number of relevant revenue cases, he laid down six points which he deemed relevant for determining whether a subsidiary is carrying on the business for its own behalf or on behalf of its parent: (a) whether the profits were treated as the profits of the parent, (b) whether the persons conducting the business were appointed by the parent company, (c) whether the parent company was the head and the brain of the trading venture, (d) whether the parent company governed the adventure, decided what should be done and what capital should be embarked on

59. *Ibid.*, p. 119.

60. *Ibid.*, p. 121.

the venture, (e) whether the parent company made the profits by its skill and direction, and (f) whether the parent company was in effectual and constant control⁶¹.

In Re F.G. Films Ltd.⁶², an American film company sought to obtain the advantages afforded to British-made films by incorporating a company in England. The English company had a capital of £100 divided into 100 shares of £1 each, 90 of which were held by the president of the American company who was also appointed as one of the three directors of the English company. The English company had no place of business other than a registered office and employed no staff.

It appeared that the English company "acted, in so far as they acted at all in the matter, merely as the nominee of and agent for an American company ..., which seems (among other things) to have financed the making of the film..."⁶³. Accordingly, it was decided that the English company could not be regarded as the "makers" of the film and, therefore, the film could not be treated as an English film⁶⁴.

In Firestone Tyre & Rubber Co. v. Lewellin⁶⁵, the House of Lords upheld a tax assessment on the basis that an English subsidiary acted as agent for its American parent company. The parent company, which was the head of a multinational corporation, formed the subsidiary in order to manufacture and sell the parent's products in Europe. Under agreements between the parent company, its European distributors and the English subsidiary, the latter (the appellants) undertook to fulfil orders for the European market obtained by the American parent but realised out of the subsidiary's own stock. In consideration of these services, the parent company undertook to pay the appellants the cost plus five per cent of the payments received; the balance was forwarded to the parent company. In practice, however, the subsidiary was fulfilling orders which it was receiving directly by the distributors without any intervention by the parent company.

All the shares in the subsidiary were held by the American parent. All the directors of the subsidiary resided in England except one who was the president of the parent and only occasionally attended meetings of the subsidiary's board. On these facts, the Court of Appeal

61. Ibid.

62. [1953] 1 All E.R. 615.

63. Per Vaisey J., *ibid.*, at 616.

64. *Ibid.*, at 615.

65. [1957] 1 All E.R. 561.

and the House of Lords held that the American parent was carrying on business in England using its subsidiary as agent and, therefore, the appellants were properly assessed in respect of their income tax as agents for the American company.

In the Court of Appeal, Evershed M.R. explained his view that the subsidiary was acting as its parent's agent as follows:

"My conclusion does not involve the proposition that [the subsidiary], instead of being an independent legal entity, is a mere branch of [the American parent]; but [the subsidiary], though a separate entity, is in fact wholly controlled by [its parent], and in making of what may be described as [the parent's] branded articles it acts under the close direction of [the parent] in all respects, and in selling those articles to [the parent's] customers it does so on terms fixed by [the parent], so that after allowing [the subsidiary] its costs and a percentage thereon the whole of the profits on the transactions go to the [parent]."⁶⁶

In Littlewoods Stores v. I.R.C.⁶⁷, the claimants sought to obtain a tax advantage relying on the fact that their wholly-owned subsidiary was a separate legal entity. The Court of Appeal decided that the claimants were not entitled to the advantage because "looking at the reality of the position and notwithstanding the Salomon v. Salomon & Co. Ltd., that subsidiary was not a separate and independent entity but a creation of the taxpayers [the parent]"⁶⁸.

Lord Denning was very careful to stress the following:

"I decline to treat the [subsidiary] as a separate and independent entity. The doctrine laid down in Salomon v. Salomon & Co. has to be watched very carefully. It has often been supposed to cast a veil over the personality of a limited company through which the courts cannot see. But that is not true. The courts can and often do draw aside the veil. They can, and often do, pull off the mask. They look to see what really lies behind. The legislature has shown the way with group accounts and the rest. And the courts should follow suit. I think we should look at the [subsidiary] and see it as it really is - the wholly-owned subsidiary of the taxpayers. It is the creature, the puppet, of the taxpayers in point of fact; and it should be so regarded in point of law."⁶⁹

66. [1956] 1 All E.R. 693 at 700.

67. [1969] 3 All E.R. 855.

68. *Ibid.*

69. *Ibid.*, at 860.

The New South Wales Court of Appeal decision of Briggs v. James Hardie & Co. Pty Ltd and Others⁷⁰ concerned an application under s. 58 of the Limitation Act 1969, for an extension of time in which to bring proceedings against a number of defendants. The applicant had contracted a disease while he was employed by a company. In the Court of first instance, he succeeded in his application to bring proceedings out of time against that company but he was denied leave to bring proceedings against two other companies. On appeal, he claimed that the two other companies were his real employer, and, in employing him, the first company acted as agent for them.

The application could be granted only if the applicant was able to show that there was evidence pointing to the possibility of a cause of action against the two companies. The applicant referred to the memorandum and the articles of association of all the companies concerned and demonstrated that the first company was, originally, a joint venture company owned by both defendants and, then, a wholly-owned subsidiary of the first defendant only. The two parent companies were given special voting rights and their nominees held special position on the board of the subsidiary. They were each entitled at any time to revoke the appointment of any director nominated or appointed by them and to replace such director. They were also alternately entitled to appoint the chairman of the board.

The two parent companies determined, *inter alia*, the destination of output, the price of the product, the decisions to be made by the board of the subsidiary and the identity of future shareholders. The control exercised by the parent companies was such that permitted the inference that "the subsidiary never acted contrary to the wishes of its parent or parents and that its activities coincided precisely with the wishes of its parent or parents"⁷¹ and that "there was no room left for a truly independent, separately functioning, corporate entity"⁷².

In supporting the majority view, Rogers A-J.A. said:

"...the relationship between Asbestos [the subsidiary company], Hardies and Wunderlich [the parent companies] was no different from the everyday situation of a holding company and its fully owned subsidiary. In everything but name, the two are as one. The holding company customarily exercises complete dominion and control over the subsidiary ... If it were to be held that during the period of joint shareholding by Hardies and Wunderlich, and later by

70. [1989] 16 NSWLR 549.

71. *Ibid.*, at 556.

72. *Ibid.*, at 567.

Hardies by itself, they were the principal and Asbestos, the agent, then that conclusion could apply in relation to just about every holding company and fully owned subsidiary and the principle of limited liability in relation to the activities of subsidiaries would be left in tatters."⁷³

Nevertheless, after a careful examination of relevant cases, he pointed out that "the law on the topic appears to be in a state of flux"⁷⁴, and he put forward the majority view that "the very uncertainty in the law demonstrates the possibility of Hardies and Wunderlich [the parent companies] being held liable after a trial"⁷⁵.

Atlas Maritime Co. SA v. Avalon Maritime Ltd., The Coral Rose (No 1)⁷⁶ concerned an appeal against a decision dismissing an application to discharge or vary a Mareva injunction. The appellant was a wholly-owned subsidiary of a Swiss parent, involved in commodity trading. In the course of its business, it purchased a damaged vessel and proceeded to make the necessary repairs with funds advanced by its parent. After entering into negotiations to sell the vessel, the respondent company regarded that a contract of sale had been concluded. When this was denied by the appellants, the respondents commenced proceedings against them for wrongful repudiation of contract and obtained a Mareva injunction over their assets.

The appellant company applied for the discharge of the injunction in order to become able to transfer the frozen funds to its parent company as a business debt owing to its creditors. In the court of first instance, Hobhouse J. refused to discharge the injunction on the ground that the relationship between the two companies was not one of debtor and creditor but rather one of agent and principal. The judge relied on evidence indicating that the appellant's operations were entirely financed and managed by its parent company and that the appellant company was in reality a mere nominee of the parent company with "no more than the barest legal existence" independently of the latter"⁷⁷.

73. *Ibid.*, at 567.

74. *Ibid.*, at 578.

75. *Ibid.*, at 580.

76. [1991] 4 All E.R. 769.

77. *Op. cit.*, at 773-774.

The Court of Appeal, also, refused to grant any variation of the injunction⁷⁸. However, it rejected the agency inference, although it accepted that the formation of the wholly-owned subsidiary, the purchase, repair and operation of the vessel were all funded by advances from the parent.

Neill L.J., referring to the Cape Industries case, argued that "a holding company is free to choose to arrange the affairs of its group in such a way that the business of the group in a particular country or for a particular project is carried on by a subsidiary. In such an event there is no presumption of agency and the company and the subsidiary can be regarded as two separate entities"⁷⁹. Similarly, Stocker L.J. argued that "the creation or purchase of a subsidiary company with minimal liability, which will operate with the parent's funds and on the parent's directions but not expose the parent to liability, may not seem to some the most honest way of trading. But it is extremely common in the international shipping industry, and perhaps elsewhere. To hold that it creates an agency relationship between the subsidiary and the parent would be revolutionary doctrine"⁸⁰.

b. A critical assessment

In all the above cases, the subsidiary was described, either expressly or impliedly, as the agent of its parent. However, the description of the subsidiary as an agent of the parent was not based on the typical elements of an agency relationship but on a number of facts suggesting that the subsidiary was closely controlled by its parent. The term agent was merely used as an epithet, interchangeably with other epithets, such as tool, simulacrum, creature, etc., in order to emphasize the substantial degree of the parent's domination over the affairs of the subsidiary.

In the only case where the court attempted to examine whether the relationship between the parent and the subsidiary was that of a principal and an agent in the strict legal sense, it was pointed out that "it is necessary to bear in mind the fundamental principle that the relationship of principal and agent can only be established by the consent of the principal and the agent"⁸¹

78. Because "the sum owed to the parent company was not a debt incurred in the course of ordinary routine trading but represented funds advanced to the defendant as trading capital and that the defendant was seeking by the proposed repayment to take action designed to ensure that subsequent orders of the court were rendered less effective". *Ibid.*, at 770.

79. *Ibid.*, at 776.

80. *Ibid.*, at 779.

81 Per Neill L.J., in *Atlas Maritime v. Avalon Maritime* (No 1), *op. cit.*, at 774.

and, in the absence of such consent in that particular case, the inference of an agency relationship was rejected.

The view that the subsidiary can be considered the agent of its parent only on a legal basis was, also, upheld in Ebbw Vale U.D.C. v. Wales Traffic Area⁸². In the Court of Appeal Cohen L.J. said the following:

"Under the ordinary rules of law, a parent company and a subsidiary company, even a 100 per cent subsidiary company, are distinct legal entities, and in the absence of an agency contract between the two companies one cannot be said to be the agent of the other."⁸³

In sharp contrast, Professor Schmitthoff proposed that, if the subsidiary is wholly-owned, there should be a rebuttable presumption that the parent uses the subsidiary as an agent⁸⁴. In the cases considered, however, complete ownership did not suffice to render the subsidiary the "agent" of the parent, even presumably. Although most of the cases virtually involved wholly-owned subsidiaries, the courts required additional evidence before describing the subsidiary as the agent of the parent: in the Roberta case, it was the supply of the majority of the subsidiary's directors by the parent and the treatment of the subsidiary's profits as profits made by the parent; in Smith, Stone & Knight v. Birmingham Corporation, it was the absence of the subsidiary's separate business, staff and book-keeping as well as the complete control of its operations by the parent; in Firestone Tyre & Rubber Co. v. Lewellin, it was the close direction of the subsidiary's operations by the parent and the transfer of the former's profits to the latter; in Littlewoods Stores v. I.R.C., it was the creation of the subsidiary for the sole purpose of benefiting the parent; in Re F.G. Films, it was the financing of the subsidiary's operations exclusively by the parent.

Notwithstanding that various expressions were used and different criteria were relied upon, all converge on the idea that a substantial degree of managerial control was exercised by the parent company. This managerial control was exercised so as to secure the operation of the subsidiary almost solely for the benefit of its parent. Therefore, it appears that the courts gave some effect to the relationship between the parent and the subsidiary company because they found that the subsidiary was not behaving in an autonomous manner; for the matters under consideration, it

82. [1951] 2 K.B. 366.

83. *Ibid.*, at 370.

84. CL. SCHMITTHOFF, *The Wholly-Owned and the Controlled Subsidiary*, J.B.L. 1978, p. 218 at 226.

was operating under the auspices and for the benefit of its parent company. In this sense, the subsidiary was described as the agent of its parent.

ii) The group as a single economic unit

In the world of business, it constitutes common sense that names like Shell, Phillips, General Motors, ICI refer to firms which operate as single economic units. In legal terms, however, parent and subsidiary companies belonging to the same group are most commonly treated as separate companies operated with a view to their own distinct interests. Nevertheless, there have been some exceptional instances where the parent and its subsidiaries have been treated as forming a single economic unit mainly on the basis of the managerial control exercised by the parent.

a. The cases

1. The DHN case

In D.H.N. Food Distributors Ltd. v. Tower Hamlets London Borough Council⁸⁵, the plaintiffs were carrying on the business of importing and distributing groceries from premises owned by their wholly-owned subsidiary. The vehicles used in the business were owned by another wholly-owned subsidiary. The three companies had common directors. The premises were compulsorily acquired by the defendants, and as a result, the plaintiffs and their two wholly-owned subsidiaries went into voluntary liquidation. The acquiring authority paid compensation only for the value of the land registered in the name of the subsidiary. The plaintiffs claimed that they were also entitled to compensation for disturbance of business and submitted three reasons for that. One of them was that the veil should be lifted and the parent company should be treated as the owners of the premises⁸⁶.

The Court of Appeal accepted all the three submissions. On the lifting the veil point, the following was concluded:

"... in the circumstances the court was entitled to look at the realities of the situation and to pierce the corporate veil. The group was virtually a partnership and for the purpose of compensation the two companies should be treated as

85. [1976] 3 All E.R. 462.

86. See also City of Glasgow District Council v. Hamlet Textiles Ltd., 1986 S.L.T. 415.

one which was effectively DHN [the parent company]. DHN were therefore entitled to claim compensation for disturbance."⁸⁷

On the same point, Lord Denning said:

"We all know that in many respects a group of companies are treated together for the purpose of general accounts, balance sheet and profit and loss accounts. They are treated as one concern. Professor Gower in his book of company law says: "there is evidence of a general tendency to ignore the separate legal entities of various companies within a group, and to look instead at the economic entity of the whole group". This is especially the case when a parent company owns all the shares of the subsidiaries so that it can control every movement of the subsidiaries. These subsidiaries are bound hand and foot to the parent company and must do just what the parent company says".⁸⁸

Goff L.J., although he was careful to stress that he would not "accept that in every case where one has a group of companies one is entitled to pierce the veil", analysed the facts of the case on the basis that "the two subsidiaries were both wholly-owned ... they had no separate business operations whatsoever... DHN could, as it were, by moving the pieces on their chess board, have put themselves in a position in which the question would have been wholly unarguable"⁸⁹. For Shaw L.J., the fact that the two companies had common interests and directors and the subsidiary was not carrying on any business of its own, indicated that there was "no flaw at all" in the "utter identity and community of interest between DHN [the parent] and Bronze [the subsidiary]"⁹⁰.

The reaction to the decision was somewhat various. According to some commentators, the result of the case on the veil-piercing issue was "all very sensible"⁹¹, "hardly surprising ... in view of the facts and the weight of authority"⁹². According to some others, however, "[a]lthough the decision is, on the facts, clearly a victory for common sense over technicality, the violence done to the corporate entity doctrine was unnecessary"⁹³; "the Court of Appeal

87. *Ibid.*, at 463.

88. *Ibid.*, at 467.

89. *Ibid.*, at 470-471.

90. *Ibid.*, at 473.

91. D. HAYTON, *Contractual Licences and Corporate Veils*, [1977] C.L.J., p. 12, at 13.

92. D. SUGARMAN & F. WEBB, "Three in One": *Trusts, Licences and Veils*, 93 L.Q.R. 1977, p. 170, at 173.

93. D. POWLES, *The See-through Corporate Veil*, 40 M.L.R. 1977, p. 339, at 342.

[in the DHN case] allowed the parent company to evade a disadvantage of an arrangement the advantages of which - one being the avoidance of stamp duties - the parent company had sought and enjoyed"⁹⁴.

In the subsequent case of Woolfson v. Strathclyde Regional Council⁹⁵, the appellant, relying on DHN, claimed compensation for disturbance caused by the compulsory acquisition of premises, occupied by a company in which he held 999 of the 1000 shares, and owned by himself and another company in which himself and his wife were the only shareholders.

Dismissing the appeal, the House of Lords held that there was "no basis consonant with principle upon which on the facts of this case the corporate veil can be pierced" to the effect of holding the appellant to be the true owner of the premises⁹⁶. Notwithstanding that the case was distinguishable on its facts from DHN, Lord Keith casted some doubt whether the Court of Appeal in the DHN case had "properly applied the principle that it is appropriate to pierce the corporate veil only where special circumstances exist indicating that it is a mere facade concealing the true facts"⁹⁷.

In Pioneer Concrete Services Ltd. v. Yelnah Pty Ltd⁹⁸, the New South Wales Supreme Court considered DHN as "one of those "too hard" cases in which judges have for policy reasons justified the lifting of the corporate veil in that particular case rather than the case which lays down any great new principle"⁹⁹. In that case, the plaintiffs, relying on DHN, tried to impute a contractual promise made by a subsidiary to the holding company. Young J. held the following:

"In my view the plaintiff's submissions take the DHN case too far and it is only if the court can see that there is in fact or in law a partnership between companies in a group or alternatively where there is a mere sham or facade that one lifts the veil. The principle does not apply in the instant case where it would appear that there was a good commercial purpose for having separate companies in the group performing different functions even though the ultimate

94. F.G. REXON, op. cit., at 420.

95. [1978] S.L.T. 159.

96. Ibid., at 162.

97. Ibid., at 161.

98. [1986] 5 N.S.W.L.R. 254.

99. Ibid., at 266, per Young J.

controllers would very naturally lapse into speaking of the whole group as "us".¹⁰⁰

Indeed, it is very difficult to assess with accuracy the scope of validity of the partnership inference, as it was laid down in the DHN case. Insofar as the decision in DHN really suggests that whenever a parent company owns all the shares of the subsidiaries and controls most of their movements, parent and subsidiaries may be treated as constituting a partnership of companies, it has far-reaching implications.

Almost invariably, parent companies own all the shares in their subsidiaries and, by virtue of formal or informal means, they are in absolute control of the subsidiaries' operations¹⁰¹. As it was pointed out in Briggs v. James Hardie & Co. Pty Ltd., "there appeared to be no special circumstances in the facts of the case [the DHN case] which differentiated it from the ordinary relationship of parent and fully owned and controlled subsidiary. Rare indeed is the subsidiary that is allowed to run its own race"¹⁰². Accordingly, in almost every case, a group of companies is to be treated as a partnership of companies, and in cases of liability every company belonging to the group will become liable jointly with the other companies of the group for all the debts of one of them.

If, on the other side, it was considered that the three companies should be treated as constituting a partnership because they "should not be treated separately so as to be defeated on a technical point" and because "they should not be deprived of the compensation which should justly be payable for disturbance"¹⁰³, the partnership analogy will apply only in order to avoid an inequitable result.

In the DHN case, segregating the group and treating parent and subsidiary companies as independent legal entities would result in the payment of an unfairly small amount of compensation. Likewise, in a case concerning the liability of the parent towards the subsidiary's creditors, treating parent and subsidiary as independent legal entities, may deprive creditors of a just and appropriate satisfaction. Tort creditors, especially, may suffer damages attributable to the managerial involvement of the parent, and, still, they may not receive

100. *Ibid.*, at 267.

101. See *supra*, ch. III, B, ii, a, c.

102. *Op. cit.*, at 572 per Rogers A-JA.

103. DHN Food Distributors Ltd. and others v. London Borough of Tower Hamlets, *op. cit.*, at 467 per Lord Denning.

appropriate compensation because of the strict adherence to the legal separation between parent and subsidiary.

The result, for instance, of the decision in the Cape Industries case was to deprive tort creditors of the subsidiary of compensation for damages suffered in the course of the operation of the group as a single economic unit under the close direction of the parent company. The court preferred to uphold Salomon and the technicalities of the legal structure and to ignore the economic reality. This result, is at great variance with the equitable considerations taken into account in the DHN case, and one wonders what would be the result of the Cape Industries case if the judges of the DHN case had been asked to decide it.

2. Other cases

In Harold Holdsworth & Co. (Wakefield) Ltd. v. Caddies¹⁰⁴, the question arose whether the appellant company was entitled to require from its managing director to devote his whole time to managing duties in its subsidiaries. It was argued by the respondent (the managing director), that the subsidiary companies were separate legal entities each under the control of its own board of directors, so that the board of the parent company could not lawfully assign any duties to anyone in relation to the management of the subsidiary companies.

The House of Lords rejected this argument and held (Lord Keith of Avonholm dissenting) that the appellant company was not in breach of its agreement with the respondent because "the appointment of the respondent to be a managing director of the appellant company by clause 1 of the agreement ... did not limit the powers of the board under the subsequent words of the agreement and, on the true construction of the clause, the respondent's duties could be confined to the management of a subsidiary company of the appellant company"¹⁰⁵.

In the agreement between the appellant company and the respondent, it was provided that the respondent, as managing director of the appellant company, should perform the duties and exercise the powers in relation to the business of the appellant and the businesses of its existing subsidiaries which might from time to time be assigned to him by the board of the appellant company (the parent).

104. [1955] 1 All E.R. 725.

105. *Ibid.*

For Viscount Kilmuir L.C., the result of that clause was "to give the power to the board to assign duties with regard to the activities of a group of companies viewed as a whole"¹⁰⁶. For Lord Morton of Henryton, the appellant company was free, under the clause "to assign to the respondent duties in relation to the business of one only, or two only or all of the companies in the group". He, further, pointed out that although "each company in the group, is in law, a separate entity, the business whereof is to be carried on by its own directors and managing director, ... there is no doubt that the appellant company [the parent], by taking any necessary formal steps, could make any arrangements they pleased in regard to the management of the business of [the subsidiary]"¹⁰⁷.

According to Lord Reid, the respondent's argument, based on the idea that the subsidiary was a separate legal entity was "too technical". Referring to the agreement between the parent company and the respondent, he continued:

"This is an agreement in re mercatoria, and it must be construed in the light of the facts and realities of the situation. The appellant company owned the whole share capital of British Textile Manufacturing Co. [the subsidiary], and ... the directors of this company were to be the nominees of the appellant company. So, in fact, the appellant company could control the internal management of their subsidiary companies, and, in the unlikely event of there being any difficulty, it was only necessary to go through formal procedure in order to make the decision of the appellant company's board fully effective."¹⁰⁸.

In Scottish Co-operative Wholesale Society Ltd. v. Meyer and Another¹⁰⁹, the appellant society, together with the respondents, formed a company in which the appellants were the majority shareholders. Of the five directors of the company, three were nominees of the appellants and the remaining two were the respondents themselves. A proposal for a realignment of the shareholding was made by the representatives of the appellants and, specifically, for the acquisition at par of a certain percentage of the respondents' shares in the company. Because the respondents refused to accept the proposal, the appellants and their nominees on the board of the company started being hostile; a policy of starving the company

106. *Ibid.*, at 730.

107. *Ibid.*, at 734.

108. *Ibid.*, at 738. On the contrary, Lord Keith, dissenting, regarded that the words of the crucial clause could not be read "as empowering the directors to force another master on the respondent". He considered that it was "no answer to say that the Textile Company is a subsidiary of the appellant company, controlled entirely as regards policy and the personnel of its board by the latter company ... [I]n law, the companies are separate persons ...". *Ibid.*, at 741.

109. [1958] 3 All E.R. 66.

of supplies on which it was dependent was adopted, and eventually, it was decided by the appellants that the company had served its purpose and it should be liquidated.

The respondents successfully petitioned for an order under section 210 of the Companies Act 1948¹¹⁰ on the ground that the affairs of the company were being conducted in a manner oppressive to them. The appellants were ordered by the court to purchase the respondents' shares at a fixed price.

The society appealed against the order submitting that even if they acted in an oppressive manner, they could not be considered as conducting the affairs of the company, as the section required. The House of Lords held that "the conduct of the appellants was oppressive and, in view of the facts that the company was a subsidiary of the appellants and that the appellants' nominees on the board of the company were participating in the policy of the appellants, was also oppressive conduct of the affairs of the company ..."¹¹¹.

Viscount Simonds said:

"... it may be that the acts of the society [the appellants] of which complaint is made could not be regarded as conduct of the affairs of the company if the society and the company were bodies wholly independent of each other, competitors in the rayon market, and using against each other such methods of trade warfare as customs permitted. But this is to pursue a false analogy. It is not possible to separate the transactions of the society from those of the company. Every step taken by the latter was determined by the policy of the former."¹¹²

A similar proposition was made by Lord Keith of Avonholm:

"In law, the society and the company were, it is true, separate legal entities. But they were in the relation of parent and subsidiary companies, the company being formed to run a business for the society."¹¹³

110. "Any member of the company who complains that the affairs of the company are being conducted in a manner oppressive to some part of the members (including himself) ... may make an application to the court by petition for an order under this section ...". This section has now been replaced by section 459 of the Companies Act 1985.

111. Scottish Co-operative Wholesale Society Ltd. v. Meyer and Another, *op. cit.*

112. *Ibid.*, at 71.

113. *Ibid.*, at 84.

In Merchandise Transport Ltd. v. British Transport Commission¹¹⁴, an application was made by a subsidiary company for a variation of a certain type of licence for vehicles. The parent held 98 out of 100 shares of the subsidiary. Many of the directors were common to both companies and it was estimated that 61% of the business of the subsidiary was carried on for the purposes of the parent company. The vehicles of the two companies were garaged at the same place.

The licensing authority dismissed the application because it regarded that granting variation of the licence would provide the whole group with an unacceptable advantage. On appeal, the Transport Tribunal granted the licence, but on appeal by the objectors, it was held that the tribunal were wrong in law in refusing to consider the relationship between parent and subsidiary company:

"The licensing authority was entitled to look at the substance of the matter - namely, that the parent and subsidiary, although separate legal persons, formed a single commercial unit."¹¹⁵

In supporting the decision, Devlin L.J. said:

"...the fact that two persons are separate in law does not mean that one may not be under the control of the other to such an extent that together they constitute one commercial unit ... Whenever a licensing authority is satisfied that sort of relationship exists, and that the dominant party is using it to obtain contrary to the intent of the Act an advantage which he would not otherwise get, he is entitled, if not bound, to exercise his discretion so as to ensure that the scheme of the Act is complied with in the spirit as well as in the letter."¹¹⁶

In Re Southard & Co. Ltd.¹¹⁷, the Court of Appeal affirmed the decision of Brightman J. to dismiss a petition by a parent company for winding up by the court of its insolvent subsidiary which was already in voluntary liquidation. The petition for winding up was supported by another company in the same group and opposed by seven independent creditors whose debts

114. [1962] 2 Q.B. 173.

115. *Ibid.*, at 175; see also Revlon Inc. v. Cripps & Lee Ltd., [1980] F.S.R. 85, where one of several companies in a group was the registered proprietor of a trademark and the court was able to conclude that the trademark was an asset of all the companies of the group on the ground of "the legal and factual position resulting from the mutual relationship of the various companies" (p. 105, per Buckley J.).

116. *Ibid.*, p. 202.

117. [1979] 1 W.L.R. 1198.

amounted to a small proportion only of the indebtedness of the petitioning and the supporting creditors.

The Court dismissed the appeal and held that:

"... on the evidence in the present case, where the petitioner was the beneficial owner of the company's shares and also the debenture holder, and where the supporting creditor was a member of the same group of companies as the petitioner, the views of the seven opposing creditors who wished the voluntary liquidation to continue in order to allow the liquidators to investigate company matters were relevant considerations which the judge had properly considered in the exercise of his discretion."¹¹⁸

Buckley L.J.¹¹⁹ agreed with the opinion of the judge in the lower court who pointed to the "family relationship" of the subsidiary to the petitioning and the supporting creditor and referred to the latter two as "domestic creditors" of the subsidiary¹²⁰. "Consequently", he argued, "the views and the wishes of the petitioner and Scandic [the supporting creditor] were likely to be, or it was at least possible that they would be, influenced by matters which do not affect trade creditors and other outside creditors of the company"¹²¹.

A more recent instance where the court seems to have accepted the idea of the economic unity of the group was in Atlas Maritime Co. SA v. Avalon Maritime Ltd. (the Coral Rose n. 3)¹²². The facts of the case were identical with the case considered above under the same name¹²³, except that the appellant applied here for variation of the Mareva injunction to enable it to pay legal fees and expenses incurred in resisting the claim against it. It was submitted that the appellant was unable to pay its solicitors otherwise than out of the frozen funds because it had no legal right to require its parent company to pay them. The judge in the Court of first instance granted the variation considering the subsidiary as an independent legal entity the liabilities of which could not be treated as liabilities of its parent.

118. *Ibid.*, at 1199.

119. For a famous dictum by Templeman L.J., see *supra*, under B, iii, fn. 47, and Introduction, A.

120. *Ibid.*, at 1206.

121. *Ibid.*, at 1205.

122. [1991] 4 All E.R. 783.

123. See *supra*, under C, i, a.

This decision was reversed in the Court of Appeal because there were reasonable grounds to believe that the subsidiary could obtain funds from its parent. The court considered that the financial relationship between the two companies as well as their common interest in the outcome of the trial was such that the parent should be reasonably expected to provide the funds necessary for the payment of legal fees¹²⁴.

This case is one of the very few cases where it was actually regarded that the parent company should discharge a liability of its subsidiary because the latter was unable to discharge it by its own means. Notwithstanding that the discharge of liability was not in fact imposed but it was left to the parent's discretion, the judges seemed to be fully convinced that the parent should pay the subsidiary's legal advisors.

Lord Donaldson M.R., explaining the reversal of the decision, held that this was not a case of "a wholly-owned subsidiary having a commercial, as distinct from a legal, existence involving some degree of independence of its parents"¹²⁵.

For Nicholls L.J., the crucial fact of the case was that parent and subsidiary were carrying on their mutual financial dealings as if they were operating a common business:

"Avalon [the subsidiary] did not maintain and operate a bank account in the usual way. Avalon seems not to have had any funds of its own. When Avalon required money to pay for a particular outgoing, whatever its nature and size, the money was provided by Marc Rich [the parent] on an ad hoc basis in respect of the particular outgoing. Conversely in respect of receipts by Avalon: all money received by Avalon seems to have been channelled straight through to Marc Rich. Thus, so far as one can see, the financial affairs of Avalon have, in substance, been conducted by Marc Rich and not Avalon. In relation to money matters, Avalon seems not to have exercised any mind of its own, even in the attenuated sense in which that frequently is the case with wholly-owned subsidiaries. Marc Rich has controlled the purse-strings, on an item-by-item basis."¹²⁶

124. This decision seems to apply a *ratio* adopted in Re Greater London Properties Ltd's Lease, [1959] 1 W.L.R. 503, where it was held that the subsidiary was a "responsible assignee" on the ground that "the parent company could have no interest but to preserve the subsidiary as part of its trading activities, and was therefore quite unlikely to demand repayment of the loan which had not been dissipated but used to improve the position of the subsidiary" (at 504). See also The Albazero, [1975] 3 All E.R. 21, CA, at 41 (Roskill L.J.).

125. *Ibid.*, at 790.

126. *Ibid.*, at 793.

He, therefore, concluded that "justice requires that Marc Rich should be left to finance Avalon's defence if it considers this a prudent commercial proposition"¹²⁷.

b. A critical assessment

In the above cases, the courts gave effect to the relationship between parent and subsidiary companies because they considered that the two companies constituted a single economic unit.

Parent and subsidiary were treated as a single economic unit when there was evidence indicating that "the parent could make any arrangements they pleased in regard to the management of the business of the subsidiary", or that "every step taken by the subsidiary was determined by the policy of the parent", or that "the subsidiaries were bound hand and foot to the parent company and must do just what the parent says" or that "the parent controlled the purse strings, on an item-by-item basis".

All these expressions were used by the courts as different ways to describe that the parent company exercised a substantial degree of managerial control over the subsidiary, at least in the matters which were under adjudication. The facts relied upon by the courts were, apart from complete or almost complete ownership of the subsidiary's shares, the appointment of all the subsidiary's directors, the participation of all or the majority of the subsidiary's directors in the formulation of the parent's policy, the absence of the subsidiary's financial independence, the integration of operations between parent and subsidiary and the community of their interests in taking a particular action.

The consequences of the decisions were also various: In DHN Food Distributors Ltd v. Tower Hamlets London Borough, a local authority was required to pay compensation for disturbance of business. In Harold Holdsworth & Co. v. Gaddies, the managing director of the parent company was required to devote his whole time to duties in relation to the subsidiary. In Scottish Co-op Wholesale Society Ltd v. Meyer, the parent company was held liable for conducting the affairs of the subsidiary in an oppressive manner. In Merchandise Transport Ltd. v. British Transport Commission, the relevant authority denied a licence to the subsidiary. In Re Southard, a petition by the parent for the compulsory winding up of its subsidiary was dismissed to the benefit of outside creditors. And finally, in Atlas Maritime Co. Sa v. Avalon Maritime Ltd, an application for variation of a Mareva injunction by the subsidiary was dismissed because it was considered that the subsidiary could obtain funds by its parent.

127. *Ibid.*, at 794.

In view of the facts of the cases and the consequences of the decisions, it is difficult to differentiate them from the cases where the courts considered the subsidiary as the agent of its parent. Complete ownership of the subsidiary's shares, cross-directorships or use of nominee directors, financial control by the parent as well as integration of operations, were used as criteria both for inferring an agency relationship as well as for establishing the existence of a single economic unit.

The attitude of the courts was inconsistent even in cases concerning the same issue and involving similar facts. Whereas in Smith, Stone & Knight v. Birmingham Corporation the subsidiary was described as the agent of the parent, in DHN the two companies were described as a single economic unit, although in both cases the facts were similar and the consequence of the decision was that the local authority was required to pay compensation for disturbance of business. The same inconsistency in the description used can be observed in Roberta case and in Atlas Maritime Co SA v. Avalon Maritime Ltd (Coral Rose no. 3), although in both cases the parent was asked to discharge a subsidiary's liability upon the finding of extensive financial control.

It seems, therefore, that the two inferences, the agency inference and the single economic unit inference, are used by the courts interchangeably, irrespective of the issue involved and the facts of the particular case. They are drawn rather as a convenient means to emphasize the managerial control by the parent than as accurate descriptions of the actual relationship between the parent and the subsidiary. By the use of either of the two analogies, the courts treat parent and subsidiary companies otherwise than as separate and independent legal entities, thereby giving effect to the substantial degree of managerial control exercised by the parent.

Thus, when a group relationship is given effect by the courts, this is done almost exclusively on the basis of the control exercised by the parent. The degree of control required has a number of characteristics:

1. It is not confined to shareholder control, i.e. to the control exercised by the parent by virtue of its majority or even its complete ownership of the subsidiary's shares.
2. In addition, managerial control is required, i.e. active involvement in the subsidiary's management overstepping the corporate formalities.
3. Managerial control is presumed especially when the same persons, either themselves or through nominees, occupy the seats in the boards of both the parent and the subsidiary, or when the parent is in charge of the financial policy of the subsidiary, or when the operations of the two companies are substantially integrated.

It is significant that only in two of the cases considered the establishment of managerial control resulted in the court considering that the parent should discharge a liability of its subsidiary. Nevertheless, the cases serve to show that the group relationship and especially the exercise of managerial control by the parent is not always ignored and courts are sometimes ready to link it with a legal consequence effecting a departure from the traditional approach, as it was established in the Salomon case.

D: THE US APPROACH

As in English law, in the United States corporate law, the generally accepted principle is that each corporation is a separate legal entity with rights and duties separate from its shareholders. This principle is not without its exceptions. The conclusions of the American courts in various cases up to 1905 were analysed by Sanborn J. in US v. Milwaukee Refrigerator Transit Co.¹²⁸, in the following terms:

"If any general rule can be laid down ... it is that a corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears but, when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons."

This principle was reaffirmed and connected with the limited liability rule in the leading case of Bartle v. Home Owners Cooperative¹²⁹ where it was stated that:

"The law permits the incorporation of a business for the very purpose of escaping personal liability. Generally speaking, the doctrine of "piercing the corporate veil" is invoked "to prevent fraud or to achieve equity."

The courts use the term "piercing the veil" where the separate existence of the corporation, as an insulation of liability, is exceptionally disregarded¹³⁰. Unlike the English case law on groups, there is a large number of American "piercing the veil" cases where the legal separation between parent and subsidiary was disregarded in order to impose liability upon the parent for

128. 142 Fed., 247 at 255 (1905).

129. 309 N.Y. 103, 127 N.E.2d 832 at 833 (N.Y. 1955).

130. H.G. HENN & J.R. ALEXANDER, *Laws of Corporations and Other Business Enterprises*, 3rd. ed., 1983, s. 73 at p. 130, ss. 146-148 at pp. 344-354; J. LANDERS, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. Chi. L. R. 1975, p. 589, at 620.

the debts of its subsidiary¹³¹. In general, exceptional circumstances for "piercing the veil" in the parent-subsidary context are found to exist when the subsidiary is so dominated and controlled by the parent company that the court concludes that it is a "mere instrumentality" or "alter ego" or "agency" or "puppet" of the parent¹³².

Notwithstanding that different metaphorical terms are used, there are no essential differences between them and they are used interchangeably by the courts to emphasize the degree of central direction and control which, in the particular case, is exercised by the parent company. The use of metaphors led to criticism by several commentators¹³³. In Berkey v. Third Avenue Railway¹³⁴, it was stated that:

"The whole problem of the relation between parent and subsidiary corporations is one that is still enveloped in the mists of metaphor. Metaphors in law are to be carefully watched, for starting as devices to liberate thought, they end often by enslaving it. We say at times that the corporate entity will be ignored when the parent corporation operate a business through a subsidiary which is characterised as an "alias" or a "dummy". All this is well enough if the picturesqueness of the epithets does not lead us to forget that the essential term to be defined is the act of operation."

The "instrumentality" or "alter ago" etc. metaphor was originally formulated by Powell in 1931¹³⁵, it was adopted in the case of Lowendahl v. Baltimore & Ohio Railroad¹³⁶, and was subsequently widely used by the courts in contract, in tort and in bankruptcy cases involving parent and subsidiary companies.

In Worldwide Carriers, Ltd v. Aris Steamship Co.¹³⁷, the court held that:

131. See PH.I. BLUMBERG, *The Law of Corporate Groups: Bankruptcy Problems in the Law of Parent and Subsidiary Corporations*, 1985, pp. 589-603 and *The Law of Corporate Groups: Tort, Contract and Other Common Law Problems in the Substantive Law of Parent and Subsidiary Corporations*, 1987, pp. 105-136, hereinafter referred to as "Blumberg, Substantive Law"; J. LANDERS, *op. cit.*, pp. 621-622.

132. For a full list of the epithets used, see PH.I. BLUMBERG, *Substantive Law*, *op. cit.*, p. 107.

133. According to R. HAMILTON, *The Corporate Entity*, 49 Tex. L. Rev. 1971, p. 979, "[t]his language is inherently unsatisfactory since it merely states the conclusion and gives no guide to the considerations that lead a court to decide that a particular case should be considered an exception to the general principle of nonliability". According to J. LANDERS, *op. cit.*, p. 626, "descriptions of the subsidiary as an "alter ego", "instrumentality", "agent" or the like are conclusory, and generalized discussions about fraudulent and unjust conduct do no more than state the problem".

134. 244 N.Y. 84, 94-95, 155 N.E. 58, 61 (1926).

135. F. POWELL, *Parent and Subsidiary Corporations*, 1931, pp. 8-24. See also, PH.I. BLUMBERG, *Substantive Law*, *op. cit.*, pp. 137-139.

136. 287 N.Y.S. 62 at 76 (1936).

137. 301 F. Supp. 64 (SDNY 1968), 67.

"In order to establish that a subsidiary is the mere instrumentality of its parent, three elements must be proved: control by the parent to such a degree that the subsidiary has become its mere instrumentality; fraud or wrong by the parent through its subsidiary, e.g. torts, violation of a statute or stripping the subsidiary of its assets; and unjust loss or injury to the claimant such as insolvency of the subsidiary."

The court then proceeded to lay down the criteria which had historically been used by the courts to determine whether a parent's control over a subsidiary would support liability. The most commonly used criteria were controlling stock ownership, common management, undercapitalisation, financing of subsidiary expenses by the parent, lack of separation of property or business, direction of the subsidiary's affairs by the parent and non-observance of formal corporate forms¹³⁸.

On the same issue, in Peterick v. State of Washington¹³⁹ it was stated that:

"Thus in addition to the usual elements of common stockholder, director and officers, the following facts have been relied on: excessive financing by the parent of the subsidiary corporation; payment of the subsidiary's expenses and losses by the parent; use by the parent of the subsidiary's property as his or its own; description by the parent of the subsidiary as part of its business; the acts of the subsidiary in the interests of the parent rather than its own interests; the fact that the subsidiary has no business except with a parent corporation, and no assets except those conveyed to it by the parent corporation; the fact that formal legal requirements such as meetings, elections and separate book-keeping devices are not observed by the subsidiary."

In Consolidated Rock Products Co. v. Du Bois¹⁴⁰, creditors of two subsidiaries challenged the fairness of a reorganization plan allowing the shareholders of the parent to participate in a new company organized to receive all the assets of the parent and subsidiary corporations and, especially, the failure of the plan to recognize any liability of the parent to the creditors of the subsidiary. Holding the parent liable for the subsidiary's debts, the Supreme Court relied on the fact that the parent, by freely commingling assets, disregarding the legal formalities and

138. *Ibid.*, at 67-68. See T.W. CASSEL, *Groups of Companies -Some US Aspects*, in CL. SCHMITTHOFF & FR. WOOLDRIDGE (ed.), *Groups of Companies*, 1991, p. 20 at 29.

139. 589 P 2d 250 at 264 (1979), citing HOROWITZ, *Disregarding the Entity of Private Corporations*, 14 Wash. L. R. 1939, p. 285, at 292-293.

140. 312 U.S. 510 (1941).

assuming all the management functions, had in effect treated the subsidiaries "as mere departments of its own business"¹⁴¹.

In Henderson et al. v. Rounds & Porter Lumber Co.¹⁴², the court held the parent responsible for the obligations incurred by its bankrupt subsidiary. In that case, the parent had forced the subsidiary to sell its lumber and flooring at a price below cost although the parent knew that this practice could force the subsidiary into bankruptcy. On these facts, it was argued that:

"Normally courts will and must respect such separate existence, but when, under the facts of a particular case, the administration of justice so requires, the fiction of corporate legal entity may be brushed aside and responsibility placed where it belongs ... Thus, in this case, if, aside from mere forms of law or legal fictions, the defendant dominated and manipulated the affairs of the Flooring Company [the subsidiary] for its own interest rather than the best interest of the Flooring Company as a separate corporate entity, and used the latter as a mere agency or instrumentality for the advancement of its own interest, and in the process of so doing inflicted damage upon these plaintiffs [the trustee in bankruptcy of the subsidiary and a subsidiary's creditor], then the court should go directly to the real party in interest, and place responsibility on the defendant."¹⁴³

In Federal Deposit Insurance Corp. v. Sea Pines Co.¹⁴⁴, the Court of Appeals for the Fourth Circuit held a parent liable for the bank debt of its insolvent subsidiary. According to the judgement, the court set aside the corporate cloak because the parent committed fundamentally unfair and unjust acts¹⁴⁵ in causing the insolvent subsidiary to mortgage an unencumbered property to secure the debts of the parent. The court was influenced by the findings of the district court that the subsidiary was 90% owned by the parent, the two companies had common directors and officers, the subsidiary was mainly financed by the parent company, the parent paid the salaries and expenses of the subsidiary, and during the period in question, the executives and officers of the subsidiary did not act independently of those of the parent¹⁴⁶.

141. *Ibid.*, at 524.

142. 99 F. Supp. 376 (W.D. Ark. 1951).

143. *Ibid.*, at 381.

144. 692 F.2d 973 (1982).

145. *Ibid.*, at 978.

146. *Ibid.*, at 975-976.

In other cases where liability was imposed on the parent for the debts of its subsidiary, the facts relied upon by the courts were, *inter alia*, the undercapitalisation of the subsidiary¹⁴⁷, the failure to observe corporate formalities and records¹⁴⁸, the great extent of actual dominance of the subsidiary's affairs by the parent¹⁴⁹ and the channelling of the subsidiary's funds to the parent¹⁵⁰.

When a combination of factors convinces the courts that the subsidiary is so dominated and controlled by the parent company that has "no separate mind, will or existence of its own"¹⁵¹, the courts may depart from the strict adherence to the entity principle and may impose liability on the parent for the debts of its subsidiary. The requirement that the parent's control must have been used so as to produce an unjust result, is defined so broadly that there is no need to establish anything other than the subsidiary's insolvency or even a mere cause of action, in addition to the excessive exercise of control. Thus, a creditor may be able to invoke the "instrumentality" or otherwise called doctrine if he merely establishes that he has an unsatisfied claim against a subsidiary which is excessively controlled by its parent¹⁵².

It may be concluded that there is no substantial difference between the English inferences of "agency" and "single economic unit" and the American "instrumentality" doctrine. Indeed, the test proposed by Atkinson J. in Smith, Stone & Knight v. Birmingham Corporation¹⁵³ might well be used as a test for inferring that the subsidiary is the "instrumentality" of the parent. Both the English inferences and the American doctrine have the effect of treating parent and subsidiary companies otherwise than independent legal entities and they heavily rely upon facts which may vary from case to case but they all converge on the idea that a substantial degree of managerial control is exercised by the parent company. Whereas the American courts have often imposed liability on the parent company on the ground of such control, the English courts have generally refrained from doing so. This may partially be explained by the predominant position that the Salomon doctrine still keeps in English company law. One wonders what

147. Taylor v. Standard Gas and Electric Co., 306 U.S. 307 (1939); Herman v. Mobile Homes Corporation, 26 N.W.2d 757 (1947); G.E.J. Corp. v. Uranium Aire, Inc., 311 F. 2d 749 (1962).

148. Consolidated Sun Ray, Inc. v. Oppenstein, 325 F.2d 801, 805 (1964); Keels v. Turner, S.E. 2d 845 (1980).

149. Commerce Trust Co. v. Woodbury, 77 F.2d 478 (1935); Taylor v. Standard Gas and Electric Co., *op. cit.*

150. Joseph R. Foard Co. v. Maryland, 219 F. 827 (1914); Wallace v. Tulsa Yellow Cab Taxi & Baggage Co., 178 Okla. 15, 61 P.2d 645 (1936); Chatterley v. Omnicco, 485 P.2d 667 (1971) at 670.

151. Lowendahl v. Baltimore & Ohio Railroad, *op. cit.*

152. D. ARONOFKY, *Piercing the Transnational Corporate Veil: Trends, Developments, and the Need for Widespread Adoption of Enterprise Analysis*, 10 N. C. J. Int'l L. & Com. Reg. 1985, p. 31 at 39; PH.I. BLUMBERG, *Substantive Law*, *op. cit.*, pp. 115-117.

153. See *supra*, under C, i, a.

would have been the outcome of cases such as the Cape Industries or the Multinational case¹⁵⁴, if American courts had been called upon to decide them.

154. See *supra*, under B.

CHAPTER VII: GROUPS OF COMPANIES IN UK STATUTORY LAW

In the UK statutory law, there is not a distinct set of rules specifically applicable to groups of companies. The rules of ordinary company law regulate the operation of groups and their relationship with third parties.

In the 1985 Companies Act, there is a limited number of provisions which regulate the parent-subsidary relationship. These provisions heavily rely on the notion of control by one company, i.e. the parent, over another, i.e. the subsidiary. Where this control relationship exists, the two companies are deemed to be parts of a parent-subsidary relationship and a number of specific provisions apply to them.

However, the liability of the parent for the debts of its subsidiary is not specifically regulated. Although the exercise of control by the parent is recognized and it is linked with a number of consequences, for liability purposes the principle remains that since parent and subsidiary constitute separate legal entities, the parent has limited liability for the debts of its subsidiary.

Exceptionally, liability may be imposed on a parent company for the debts of its subsidiary by virtue of a limited number of statutory provisions, such as the provisions on fraudulent and wrongful trading¹. These provisions are not specifically applicable to parent and subsidiary companies; they generally refer to circumstances where liability for the debts of a company is imposed on persons other than the company itself. By virtue of these provisions, liability may be imposed on the parent for the debts of its subsidiary where the parent is found to exercise a certain degree of managerial control over the subsidiary.

Thus, both set of provisions, i.e. the provisions which are expressly applicable to the parent-subsidary relationship and the provisions according to which liability may be imposed on the parent company, employ a variation of control as a precondition for their application.

1. See below, under B.

A: GENERAL STATUTORY PROVISIONS APPLICABLE TO GROUPS OF COMPANIES

i) The definitions

In the 1985 Companies Act there is not a general definition of groups of companies. Sometimes, the group is defined as the holding company together with its subsidiaries², but this seems to be a rather casual definition, which, in any case, is not intended to have general application.

There are, however, two different definitions of the parent-subsidary relationship which apply for different purposes, use different terms and employ different criteria.

For all purposes other than accounting, the companies belonging to a group are designated as "holding companies" and "subsidiaries"³ and, therefore, they can be only corporate bodies. Section 736(1) defines a company as the subsidiary of another company, its holding company, if:

- (a) that other company holds a majority of voting rights in it, or
- (b) that other company is a member of it and has the right to appoint or remove directors of it who together can exercise more than half of the voting rights exercisable at its board meetings, or
- (c) that other company is a member of it and controls alone, pursuant to an agreement with other shareholders or members, a majority of the voting rights in it, or
- (d) it is a subsidiary of a company which is itself a subsidiary of that other company.

For accounting purposes, i.e. mainly for the obligation of a parent company to prepare consolidated annual accounts for the group as a whole⁴, the parent and subsidiary are designated as "parent undertaking" and "subsidiary undertaking". An undertaking is defined as a body corporate, a partnership, or an unincorporated association carrying on a trade or a business with or without a view to profit⁵. A parent is obliged to prepare consolidated accounts only if it is a corporate body⁶.

2. Companies Act 1985, s. 319 (7) (b), s. 333; see also s. 262 (1).

3. Ibid., s. 736 (1).

4. See *supra*, ch. V, A.

5. CA 1985, s. 259 (1).

6. Ibid., s. 227 (1).

An undertaking is a parent undertaking in relation to another undertaking, the subsidiary undertaking, if:

- (a) it holds a majority of the voting rights in the undertaking, or
- (b) it is a member of the undertaking and has the right to appoint or remove directors of it who together can exercise more than half of the voting rights exercisable at its board meetings, or
- (c) it has the right to exercise a dominant influence over the undertaking:
 - (i) by virtue of provisions contained in the undertaking's memorandum or articles, or
 - (ii) by virtue of a control contract, or
- (d) it is a member of the undertaking and controls alone, pursuant to an agreement with other shareholders or members, a majority of the voting rights in the undertaking⁷, or
- (e) it is the parent undertaking of another undertaking which is itself the parent undertaking of a third undertaking, the subsidiary undertaking⁸, or
- (f) it has a participating interest in the undertaking (i.e. an interest in the undertaking's shares held on a long term basis for the purpose of securing a contribution to the undertaking's activities by the exercise of control or influence arising from or related to that interest, it being presumed that a holding of 20% per cent or more of an undertaking's issued share capital is a participating interest in it unless the contrary is shown)⁹, and:
 - (i) it actually exercises a dominant influence over it, or
 - (ii) it and the subsidiary undertaking are managed on a unified basis¹⁰.

A right to exercise a dominant influence is a right to give directions with respect to the operating and financial policies of another undertaking which its directors are obliged to comply with whether or not they are for its benefit¹¹. A control contract is a contract in writing conferring a right to exercise a dominant influence. It must be authorised by the memorandum or the articles of the undertaking in question and must be permitted by the law under which that undertaking is established¹².

The new definition for accounting purposes was dictated by the obligation of the English legislature to implement the Seventh Directive¹³. According to art. 1 (2) of the Directive, the

7. *Ibid.*, s. 258 (2).

8. *Ibid.*, s. 258 (5).

9. *Ibid.*, s. 260.

10. *Ibid.*, s. 258 (4).

11. *Ibid.*, Sch. 10A, para 4 (1).

12. *Ibid.*, Sch. 10A, para 4 (2).

13. Council Directive (EEC) 83/349 (OJ L 193 18.7.83 p1); *see supra*, ch. V, A.

inclusion of the criterion (f) in the definition was left to the discretion of the Member States. Thus, in introducing this criterion, the English legislature has gone beyond the minimum necessary to implement the Directive, apparently in order to encompass any form of company interdependence within the consolidation requirement.

However, it is provided that the definition of the term "the right to exercise a dominant influence" shall not be read as affecting the construction of the expression "actually exercises a dominant influence"¹⁴. This expression is, therefore, open to interpretation, as is the expression "managed on a unified basis". Thus, it is uncertain what degree of dominant influence a parent undertaking must actually exercise or to what extent the two undertakings must be managed on a unified basis in order to establish a parent-subsidary relationship under (f).

There is a significant difference between the two sets of definitions. For other than accounting purposes, the parent-subsidary relationship is established merely on the basis of formal legal criteria such as the holding of the majority of voting rights either in the general meeting or in the board of the subsidiary. For accounting purposes, however, in addition to the same formal criteria, a number of non-legal criteria are introduced, such as the right to exercise or the actual exercise of a dominant influence by the parent or the management of parent and subsidiary on a unified basis.

The establishment of the parent-subsidary relationship on the basis of legal criteria relies upon the control which is normally exercised by any majority shareholder. The holding or the control of the majority of voting rights either in the general meeting or in the board of directors of the subsidiary company are the legal means through which the parent company has the power to control the subsidiary.

The establishment of the parent-subsidary relationship on the basis of non-legal criteria relies upon the economic dependence of the subsidiary on its parent. When one company has the right to exercise a dominant influence over another, or it actually exercises such a dominant influence, or when the two companies are managed on a unified basis, a parent-subsidary relationship is established irrespective of whether the parent company holds or controls the majority of the voting rights in the general meeting or in the board of the subsidiary.

14. *Ibid.*, Sch. 10A, para 4(3).

The existence of a control contract between parent and subsidiary, the right to exercise or the actual exercise of dominant influence by the former over the latter, and the management of the two on a unified basis, are all criteria which have in fact been imported from the legal regulation of groups in Germany. In Germany, however, they are all employed for general purposes and they are, to a certain extent, clarified; control contracts are often used and the concepts of dominant influence and unified management have undergone substantial elaboration by the courts¹⁵.

On the contrary, in the UK control contracts are rarely entered into by companies and the concepts of dominant influence and unified management have not been clarified¹⁶. It is possible that guidance on interpretation will form part of a future accounting standard. At present, however, these concepts do not have a precise legal meaning and even if they were made applicable for other than accounting purposes, they could not provide a workable definition of the parent-subsidiary relationship.

ii) Other statutory provisions

Despite the absence of a general definition of groups of companies, there is a number of non-accounting statutory provisions which are applicable to holding and subsidiary companies, as they are defined in CA 1985, s. 736.

For instance, a subsidiary or its nominee cannot be a member of its holding company, and any allotment of shares in the holding company to a subsidiary or its nominee is void¹⁷. The prohibition does not apply if the subsidiary is merely concerned as personal representative or trustee and neither the holding company nor the subsidiary is beneficially interested in the shares¹⁸, or if the subsidiary is a market maker¹⁹.

However, a subsidiary which was a member of its holding company before the introduction of the above prohibition or a company which was not a subsidiary under the previous definitions may continue to be members of their holding companies and may be allotted further fully paid shares on a capitalization of their reserves. In either case, however, the subsidiary has no right

15. See below, ch. VIII, A.

16. R.R. PENNINGTON, *Pennington's Company Law*, 6th ed., 1990, p. 736.

17. CA 1985, s. 23 (1).

18. *Ibid.*, s. 23 (2).

19. *Ibid.*, s. 23 (3).

to vote at general meetings of the holding company nor at meetings of any class of its members, in respect of the shares held or allotted²⁰.

Section 151 extends the prohibition of direct or indirect financial assistance by a company for the acquisition of its own shares to financial assistance given by its subsidiary company. Section 330 (2) (a) extends the prohibition of a loan by a company to its own directors to a loan given to the directors of its holding company. Section 320 on substantial property transactions between the company and its own directors extends the prohibitions to transactions between the company and the directors of its holding company.

Section 323 on dealing in share options by directors extends the prohibition to dealing in options of other companies belonging to the same group; section 324 on the duty of directors to disclose shareholding in their own company extends the duty of disclosure to shareholding in the other companies of the same group.

Also, for the purpose of certain provisions of the Act, a holding company is considered a shadow director of its subsidiary. The provisions in question are all those in respect of which shadow directors are to be treated as directors, with a number of exceptions²¹. For the purpose of these provisions, where the board of the subsidiary is accustomed to act in accordance with the instructions and the directions of the holding company, the holding company is treated as a member of the subsidiary's board of directors²².

Viewed as a whole, these provisions can be regarded as constituting a distinct part of the Companies Act. Whereas the rest of the statute heavily relies on the notion of the company as a separate legal entity with its independent interests and its independent board, these provisions give effect to the group relationship. On the basis of the control exercised by the parent, parent and subsidiary are treated as though they were a single company or the parent company is treated as though it was the director of its subsidiary.

Acquisition by the subsidiary of shares in its parent or financial assistance for such acquisition is treated as acquisition or financial assistance by the parent itself. The directors of the parent company are treated as if they were directors of the subsidiary itself and, in some instances, the

20. *Ibid.*, s. 23 (4), (6) and (7).

21. *Ibid.*, s. 741 (3); see also R.R. PENNINGTON, *op. cit.*, pp. 531, 738.

22. *Ibid.*, s. 741(2), (3).

parent itself is treated as if it was a director of its subsidiary although it has never been appointed to that position.

B: STATUTORY PROVISIONS ON LIABILITY APPLICABLE TO GROUPS OF COMPANIES

i) Liability of the sole member

a. The provision

The association of a certain number of persons was always considered to be necessary condition for the creation and operation of an English limited liability company. Before the Companies Act 1980, the reduction of the members of a public company below seven and of a private below two, rendered, under certain circumstances, the remaining members liable for the contracted debts of the company²³.

The Companies Act 1980 equated public with private companies and provided for the situation where a company, private or public, carries on business for more than six months with fewer than two members. Any person who is the only remaining member²⁴ after the period of six months and who, additionally, knows that the company is carrying on business with himself as its only member, is liable, jointly and severally with the company for its debts contracted during the period after the six months²⁵.

Very recently, the scope of this provision has been restricted to public companies. By virtue of the Companies (Single Member Private Limited Companies) Regulations 1992, which implemented the EC Twelfth Company Law Directive²⁶, s. 24 of the 1985 Companies Act imposing personal liability on the sole remaining member of a company, no longer applies in the case of a private company. The sole member of a company becomes liable for the debts contracted by the company during the relevant period, only if the company is a public company and the other requirements of the provision are met.

23. *Companies Act 1948*, s. 48.

24. "This situation may be brought about either by the death of members, for personal representatives do not become members in place of a deceased shareholder until they are entered on the register of members, or by shareholders transferring all their shares to one of their own number." R.R. PENNINGTON, *op. cit.*, p. 39.

25. CA 1985, s. 24.

26. Council Directive (EEC) 89/667 (OJ L 395 30.12.89 p40).

b. The applicability of the provision in the parent - subsidiary context

When the provision refers to the sole member of the company it refers not only to a natural person but to a legal one, as well. Thus, a subsidiary which is a public company, should have, just as any other public company, at least two members; otherwise, the parent, as the only member, will become liable for the debts of the subsidiary.

However, a member of a public company may virtually own all its shares and may be in absolute control of its operations, and, still, may be able to avoid personal liability under s. 24. Because section 24 fails to discriminate between real and nominee shareholders, i.e. shareholders who hold shares in their own names but for the benefit of somebody else, a public company may appear to consist of two or more members with limited liability although there is only one member who really owns the company's shares. Thus, a parent company can register part of the subsidiary's shares in the names of nominees in order to avoid liability under s. 24. The fact that the subsidiary is described as a wholly-owned one does not necessarily mean that the parent company is liable for its debts.

It appears that the imposition of liability on the sole member of an one-man public company or a wholly-owned public subsidiary cannot be effective unless there is contemplation of the possibility of the shares being held by nominees and a way of ascertaining who is a nominee and who is the person on whose interest the shares are held. As the section currently stands, however, it is improbable that it will ever be invoked.

For theoretical purposes only, it should be pointed out that liability may be imposed on the parent only for debts contracted by its wholly-owned subsidiary. Liability for obligations other than contractual debts, such as obligations arising out of a breach of contract, a tort, or obligations to pay salaries to employees, is not contemplated. The section clearly purports to operate only in favour of the financial creditors of the company who will normally be sophisticated banks and financial institutions²⁷.

On the contrary, the rest of the creditors fall outside the scope of application of the section. Trade creditors and employees may be contractual creditors but the contract they enter into with the company is not a contractual debt, as the section requires. Tort creditors do not enter a contract at all, since their claim arises in an unpredicted manner. Even if any of these creditors manages to obtain a judgement against the wholly-owned subsidiary, the judgement cannot be

27. See *supra*, ch. II, A, iii, a and ch. IV, A, iii, a.

enforced against the parent, because the judgement debt is not a debt contracted by the company, as the section requires²⁸. Hence, the majority of creditors and especially those who are in the greatest need for statutory protection when companies are consisting of only one member, are excluded by the wording of section 24.

c. The Twelfth EC Directive and the difference between one-man companies and wholly-owned subsidiaries

As it is already mentioned, section 24 of the Companies Act 1985 now applies only in public companies in compliance with the Twelfth EC Directive on single-member private limited liability companies²⁹. Article 2 of the Directive provides that a limited liability company (a continental form which is similar to the English private company), may have a sole member when it is formed and also when all its shares come to be held by a single person.

In the preamble of the Directive, it is stated that "Member States may in specific cases lay down restrictions on the use of single-member companies or remove the limits on the liabilities of sole members" and that "Member States are free to lay down rules to cover the risks that single-member companies may present as a consequence of having single members, particularly to ensure that the subscribed capital is paid"³⁰.

It is also provided that the Directive shall have no immediate effect for the case where the single-member company is a wholly-owned subsidiary. Section 2(2) of the Directive provides that:

"Member States may, pending co-ordination of national laws relating to groups, lay down special provisions or sanctions for cases where:

- (a) a natural person is the sole member of several companies,
- (b) a single-member company or any other legal person is the sole member of a company.

Therefore, where a legal person is the sole member of another legal person or a natural person is the sole member of several legal persons, the relevant provisions of national laws are not affected and may even prohibit the operation of such wholly-owned companies. However, in implementing the Directive, the English Department of Trade and Industry took the view that

28. R.R. PENNINGTON, *op. cit.*, p. 39, fn. 5.

29. *Op. cit.*

30. *Op. cit.*

there was unlikely to be any abuse, so no special provision was made³¹. Thus, as the English provision currently stands, a parent company is not liable for the debts of a wholly-owned subsidiary which has the form of a private company.

It may appear, at first sight, that, as far as the liability of the sole member is concerned, there is no substantial difference between single-member companies where the sole member is an individual and wholly-owned subsidiaries where the sole member is the parent company. Just as, within a group a parent company typically manages its wholly-owned subsidiaries, the sole shareholder manages the one-man company. In both cases, there is no separation between ownership and management. Accordingly, if there is a good reason for imposing liability on the parent for the debts of its wholly-owned subsidiary, there is an equally good reason for imposing liability on the sole owner of the one-man company.

However, if liability is imposed on the sole natural person who owns the company, all his personal belongings, including his house, his car, his furniture can be reached by the company's creditors. In this case, the historical purpose of limited liability, i.e. the encouragement for wide participation of the investing public in the economic activity, is largely defeated. In the case, though, that liability is imposed on the parent company of a wholly-owned subsidiary, the personal belongings of individual investors are not in danger. What is in danger is the factory, the stock, the premises and the warehouses of the parent company, which are assets which limited liability never did purport to protect. The individual shareholders of the parent are still protected by limited liability and prospective investors are still encouraged to invest without risking their entire wealth.

Moreover, in the one-man company, the sole owner is expected to run the company as a sole trader, taking care of the interests of the business and seeking for the maximization of its profitability. In the typical group, however, one company, i.e. the wholly-owned subsidiary is controlled according to the will and in the interests of another company, i.e. the parent³². These interests may coincide, for instance when both companies are managed with a view to the profitability and the reputation of the group as whole; they may equally, however, conflict, especially when it is to the interests of the group to close down one subsidiary or to operate it at a loss³³. In these circumstances, it would be unreasonable to allow the parent company to

31. *Bus. L. Rev.* 1992, p. 81.

32. See *supra*, ch. III, B, ii, c.

33. J.H. FARRAR, N.E. FUREY, B.M. HANNIGAN, *Farrar's Company Law*, 3rd ed., 1991, p. 538; J.M. LANDERS, *A Unified Approach to Parent, Subsidiaries and Affiliates in Bankruptcy*, 42 *U. Chi. L. Rev.* 1975, p. 589 at 591.

operate its subsidiary without any risk of loss apart from that prescribed by the limited liability rule³⁴.

Hence, the Directive rightly restricted its scope of application only to single-member companies and left the regulation of wholly-owned subsidiaries to the discretion of Member States pending co-ordination of national laws relating to groups. Notwithstanding that, in practice, parent companies normally arrange their affairs so as to have limited liability for the debts of their wholly-owned subsidiaries, the legalization of this situation by virtue of an EC Directive would have had far-reaching effects and would have defeated any attempt to bring the law regulating groups into conformity with economic reality.

ii) Fraudulent trading

a. The provision

An early provision with some elements of fraudulent trading is to be found in the Limited Liability Act of 1855³⁵. Section ix of that Act provided that:

"If the Directors of any such Company shall declare and pay any Dividend when the company is known to be insolvent, or any dividend the payment of which would to their knowledge render it insolvent, they shall be jointly and severally liable for all the Debts of the Company then existing, and for all that shall be thereafter contracted, so long as they shall respectively continue in office; provided that the Amount for which they shall be so liable shall not exceed the amount of such Dividend, and that if any of the Directors shall be absent at the Time of making the Dividend, or shall object thereto, and shall file their Objection in Writing with the Clerk of the Company, they shall be exempt from the said Liability."

The current concept of fraudulent trading was introduced as a result of the Greene Committee's Report on Company Law Amendment³⁶. The Committee identified in private companies in liquidation a practice of creating floating charges in favour of the company's controllers at the expense of the unsecured creditors. The relevant paragraphs of the Committee's report read as follows:

34. See H. COLLINS, *Ascription of Legal Responsibility to Groups in Complex Patterns of Economic Integration*, 53 M.L.R. 1990, p. 731.

35. 18 & 19 Vict. c. 133.

36. Cmnd. 2657 (1926).

"Our attention has been directed particularly to the case (met with principally in private companies) where the person in control of the company holds a floating charge and, while knowing that the company is on the verge of liquidation, "fills up" his security by means of goods obtained on credit and then appoints a receiver ... We consider that not only should the person whom the court finds to have been guilty of fraudulent trading, etc., be subjected to unlimited personal liability, but that any security over assets of the company held by him or on his behalf, and assigned to anyone save a bona fide holder for value should be charged with the liability. Further, trading of this character should be made a criminal offense"³⁷.

Thus, section 75 of the Companies Act 1928, which was later consolidated in section 275 of the Companies Act 1929, provided that, in certain circumstances, those who were responsible for carrying on a company's business after it had become insolvent might be made personally liable for the company's debts and might also be liable to criminal penalties. Whereas according to the 1929 provision, only directors could be made liable, section 332 of CA 1948 was made applicable to any persons knowingly parties to the carrying on of the company's business with intent to defraud creditors. In the legislative reforms of 1985-1986 the criminal offense became section 458 of the Companies Act and the civil sanction was moved to section 213 of the Insolvency Act 1986.

Section 213 provides for the situation where "in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose"³⁸. The persons "who were knowingly parties to the carrying on of the business" in this fraudulent manner may be declared by the court, on the application of the liquidator, "liable to make such contributions to the company's assets as the court thinks proper"³⁹.

b. The requirements

For the application of the provision four requirements have to be met:

- i) the company should be at the stage of winding up,
- ii) application to court must be made by the liquidator,

37. *Ibid.*, paras. 61-62.

38. *Insolvency Act 1986*, s. 213 (1).

39. *Ibid.*, s. 213 (2).

- iii) the business of the company must have been carried on with intent to defraud its creditors and
- iv) the persons on whom liability is imposed should be knowingly parties to the carrying on of the business in a fraudulent manner.

If all the requirements of the provision are met, the court may order the person in default to make a contribution to the company's assets. These assets will be used to satisfy the claims of all the company's creditors, whether loan, trade or tort creditors, subject of course, to their established order of priority.

It is significant that the liability imposed is not a direct one because the person charged with fraudulent trading may be ordered by the court only to make a contribution to the assets of the company and not to satisfy directly the creditor defrauded. On the contrary, under the 1948 version of the provision, it was decided that the court could order, instead of a contribution to the company's assets, direct satisfaction of the defrauded creditors⁴⁰.

The first two requirements do not create any particular problem since they concern questions of fact. Mention should only be made of the fact that the current provision operates only after application by the liquidator and application by any other person is not sufficient, whereas, under the 1948 version, an application by a member of the company or a creditor was equally effective.

1. The "intent to defraud" requirement

The "intent to defraud creditors or for any other fraudulent purpose" requirement has been subjected to various interpretations. Two different statements made by Maugham J. within one year are very difficult to reconcile. The first was made in the case of Re William C. Lietch Ltd.⁴¹ where a company was insolvent but its directors continued to carry on its business by purchasing further goods on credit. Declaring one of them personally liable for the price of those goods, the judge said:

"if a company continues to carry on business and to incur debts at a time when there is to the knowledge of the directors no reasonable prospect of the creditors ever receiving payment of those debts, it is, in general, a proper

⁴⁰. Re Cyona Distributions Ltd. [1967] Ch 889, [1967] 1 All ER 281; Re Gerald Cooper Chemicals Ltd. [1978] Ch 262, [1978] 2 All ER 49.

⁴¹. [1932] 2 Ch. 71 at 77.

inference that the company is carrying on business with intent to defraud ..."

This statement has been approved in a more recent, unreported decision⁴², where it was stated that a person who incurs further credit in the hope of discharging the company's liabilities at some indefinite time in the future is not liable for fraudulent trading:

"... there is nothing wrong in the fact that directors incur credit at a time when, to their knowledge, the company is not able to meet all its liabilities as they fall due. What is manifestly wrong is if directors allow a company to incur credit at a time when the business is being carried on in such circumstances that it is clear the company will never be able to satisfy its creditors. However, there is nothing to say that directors who genuinely believe that the clouds will roll away and the sunshine of prosperity will shine upon them again and disperse the fog of their depression are not entitled to incur credit to help them get over the bad time."⁴³

In R v. Grantham⁴⁴ a less strict test was proposed. It was held that the proper test to infer intent to defraud creditors is not whether the directors believe that the company will be able to pay its debts some time in the future, but whether they have reason to believe that the company, in incurring further credit, can pay its debts as they fell due or shortly thereafter:

"... if a man honestly believes when he obtains credit that although funds are not immediately available he will be able to pay them when the debt becomes due or within a short time thereafter, no doubt you would say that is not dishonest and there is no intent to defraud, but if he obtains or helps to obtain credit or further credit when he knows there is no good reason for thinking funds will become available to pay the debt when it becomes due or shortly thereafter then ... you might well think that is dishonest and there is an intent to defraud."⁴⁵

42. Re White & Osmond (Parkstone) Ltd., a decision of Buckley J. in 1960, mentioned in R v. Grantham (see below), and referred to in R.M. GOODE, *Principles of Corporate Insolvency Law*, 1990, p. 202.

43. See also, Hardie v. Hanson, (1960) 105 C.L.R. 451 at 467, a decision of the High Court of Australia, where it was held that there would not be a breach of the section "even if the chances of payment of all a company's creditors in full were so remote that it belonged to the realms of hope rather than belief".

44. [1984] 3 All ER 166.

45. Per Lord Lane C.J., *ibid*, p. 169.

The alternative interpretation of the "intent to defraud" requirement by Maugham J. was put forward in the case of Re Patrick and Lyon Ltd.⁴⁶. In that case, an order was sought against a director who had allegedly continued the company's business not genuinely for trading purposes but solely in order that certain debentures which the company had issued to him would not be invalidated under the fraudulent preference provision (then s. 322 of the CA 1948). Being of the opinion that this conduct did not constitute fraudulent trading, the judge said the following:

"... the words defraud and fraudulent purpose, where they appear in the section in question, are words which connote actual dishonesty involving, according to current notions of fair trading among commercial men, real moral blame."⁴⁷

According to Farrar, the two statements of Maugham J. can be reconciled on the basis that the latter "reflects the true substantive legal position while the earlier one merely gives practical guidance on the evidence required"⁴⁸. This reconciliation took place in the case of Re a Company No. 001418 of 1988⁴⁹, where a combination of the two tests was proposed. Holding that the respondent managing director and majority shareholder of the company was liable under s. 630 of the CA 1985 (the former fraudulent trading provision), His Honour Judge Leonard Bromley QC, said the following:

"A finding that a person was knowingly party to the business of the company having been carried on with intent to defraud creditors may be made if the following two conditions are satisfied:

- (1) if that person realised at the time the debts were incurred that there was no reason for thinking that funds would be available to pay the debt in question when it became due or shortly thereafter; and
- (2) there was actually dishonesty involving, according to current notions of fair trading among commercial men, real moral blame."⁵⁰

Whichever view one takes of its interpretation, the "intent to defraud" requirement poses almost unsurmountable difficulties for the application of the fraudulent trading provision. It will be very difficult for the plaintiff to establish fraud, either in the form suggested in Re William C. Leitch according to which there is no need to establish moral blame, or in the form of criminal

46. [1933] Ch. 786.

47. *Ibid.*, at 790; the same test was applied by Harman J. in the recent case of Re L Todd (Swanscombe) Ltd., ChD, [1990] BCC 125 at 128.

48. J.H. FARRAR, *Fraudulent Trading*, J.B.L. 1980, p. 336 at 341.

49. ChD, [1990] BCC 526.

50. *Ibid.*, at 527.

fraud suggested in Re Patrick Lyon Ltd. or in the combined form suggested in Re a Company No. 001418 of 1988.

The difficulty of meeting the "intent to defraud" requirement led the Jenkins Committee to recommend the introduction of a remedy for reckless trading without the need to establish fraudulent intent⁵¹. Twenty years later, the Cork Committee made a similar recommendation which led to the introduction of the current wrongful trading provision⁵², because it considered that the difficulty of meeting the same requirement enabled directors or others involved in the management of a company to avoid liability in many cases⁵³.

2. Persons covered: applicability to parent-subsidiary

Although the intention of the Greene Committee was to cover, in general, "the person in control of the company"⁵⁴, section 75 of the Companies Act 1928 was made specifically applicable to "any directors whether past or present who were knowingly parties to the carrying on of the business". The Cohen Committee in 1945 recommended the extension of the provision "to other persons who were knowingly parties to the frauds"⁵⁵. Accordingly, the provision currently covers "any persons who were knowingly parties to the carrying on of the business".

In the wording "person knowingly party to the carrying on of the business", a director who personally manages the company is undoubtedly included⁵⁶. The question arises whether the provision covers also persons who exercise influence over the directors by customarily giving them instructions or directions, but they do not personally participate in the management, the so-called shadow directors⁵⁷.

Although the provision does not explicitly require active and personal participation in the management of the company, such a condition is inferred from the absence of any indication

51. Report of the Committee on Company Law Reform, Cmnd. 1749 (1962), para. 503 (b).

52. See below, under iii.

53. Insolvency Law Review Committee, *Insolvency Law and Practice*, Cmnd. 8558 (1982), chap. 44, para. 1776.

54. Cmnd. 2657 (1926), op. cit.

55. Cmnd. 6659 (1945), para. 149.

56. Compare with the wording used in Insolvency Act 1986, s. 214 (1), (7) which explicitly refers to directors and shadow directors of the company and with the Irish Companies (Amendment) Act 1990, s. 33 (1)(a) which refers to an officer of the company.

57. A shadow director is, according to s. 741 of the Companies Act 1985, "a person in accordance with whose directions or instructions the directors of the company are accustomed to act".

to the contrary. Unlike section 214 of Insolvency Act on wrongful trading, the provision of fraudulent trading does not make itself directly applicable to shadow directors⁵⁸. A person is considered "knowingly party to the carrying on of the business", only if he either personally took part in making the decision to enter or he specifically instructed the company's management to enter a transaction which was intended to defraud creditors. The fact that one person, e.g. a controlling shareholder, is generally accustomed to give instructions to which the directors normally submit, does not suffice⁵⁹.

Accordingly, a parent company may become liable under s. 213 only if it can be shown that the parent itself has deliberately caused the subsidiary to enter a transaction with intent to defraud the latter's creditors. The mere fact that the subsidiary's business is customarily conducted on the basis of the parent's instructions or directions does not suffice. It is not sufficient, therefore, to show that the parent is, in general, the shadow director of the subsidiary; it is necessary to prove that the parent acted as a shadow director particularly in relation to the transaction complained of, with intent to defraud the subsidiary's creditors.

However, in Re Augustus Barnet & Son Ltd.⁶⁰, it was decided that, even if the parent company acted fraudulently, it was not a party to the carrying on of the business of its subsidiary with intent to defraud since the persons who personally managed the subsidiary under the supervision of the parent showed no fraudulent intent.

The case concerned an application by the liquidators of a subsidiary for a declaration under s. 332 of the CA of 1948 (the former fraudulent trading provision), that the parent company was knowingly party to the carrying on of the business of the subsidiary with intent to defraud its creditors and should be responsible for the subsidiary's debts.

Throughout a period during which the subsidiary faced serious financial difficulties, the parent company made statements both to the board of the subsidiary and in public that it would continue to support the subsidiary financially. When the parent refused to provide the promised support, the subsidiary went into creditors' voluntary liquidation with an estimated deficiency of £4.5 m. for unsecured creditors.

58. Insolvency Act 1986, s. 214 (7).

59. R.R. PENNINGTON, *op. cit.*, p. 43.

60. [1986] 2 BCC 98, 904.

The liquidator alleged that, by providing letters of comfort, subsidies and making statements of intention to continue support, the parent company had induced the subsidiary's board to carry on its business and had induced suppliers and creditors to do business with it. Therefore, due to the deliberate failure to honour these undertakings and to support the subsidiary, the parent had been party to the carrying on of the subsidiary's business with intent to defraud.

However, Hoffmann J., striking out the declaration for fraudulent trading, said the following:

"The words "persons ... party to" may be wide enough to cover outsiders who could not be said to have carried on or even assisted the carrying on of the company's business but who nevertheless in some way participated in the fraudulent acts ... But I cannot see how the requirements of the section can be satisfied if no fraudulent intent is alleged against any person who actually carried on the business. In such a case, there are no fraudulent acts to which the outsider can have been a party and his own state of mind seems to me for present purposes irrelevant."⁶¹

Despite the decision in Re Augustus Barnett, a parent company may still be found to carry on the subsidiary's business with intent to defraud its creditors. In Re Gerald Cooper Chemicals Ltd.⁶², a company accepted an advance payment by a client, allegedly with no prospect or intention to supply the goods. Subsequently, a creditor of the company accepted repayment of the debt due to him although he knew that the payment was made by the funds fraudulently obtained by the client. Holding that the points of the client's claim for a declaration under s. 332 of the CA 1948 against the creditor establish a cause of action, Templeman J. said:

"I agree that a lender who presses for payment is not party to a fraud merely because he knows that no money will be available to pay him if the debtor remains honest. The honest debtor is free to be made bankrupt. But in my judgement a creditor is party to the carrying on of the business with intent to defraud creditors if he accepts money which he knows full well has in fact been procured by carrying on the business for the very purpose of making the payment."⁶³

Accordingly, a parent may be considered as carrying on the subsidiary's business with intent to defraud the subsidiary's creditors, if it advances credit to a subsidiary and then presses for

61. *Ibid.*, at 907.

62. 1 Ch [1978] 263.

63. *Ibid.*, at 268.

repayment out of funds which the subsidiary fraudulently received from other creditors at the parent's behest.

In these circumstances, subsections 215 (2) and (4) of the Insolvency Act 1986, broaden significantly the discretion of the court. If, according to the line of reasoning in Re Gerald Cooper Chemicals Ltd, it can be established that the parent company which advanced credit to its subsidiary, is a party to the carrying on of the subsidiary's business with intent to defraud the latter's creditors, the court, according to s. 215 (2)(a) may charge the amount which the parent is liable to contribute under s. 213 on any debt or obligation due from the subsidiary to the parent, or on any mortgage or charge on the subsidiary's assets held by the parent. Alternatively, the court, according to s. 215 (4), may direct that the debt owed by the subsidiary to the parent shall rank in priority after all other debts owed by the subsidiary to external creditors.

In Re Sarflax⁶⁴, however, the court refrained from holding a parent company liable for fraudulent trading, because it considered that the mere preference of one creditor over another does not, *per se*, constitute fraud within the meaning of the provision. In that case, the liquidator of a wholly-owned subsidiary sought a declaration under s. 332 of the Companies Act 1948 that the subsidiary's business had been carried on with intent to defraud creditors and, in particular, an Italian company having a claim for damages.

The subsidiary had ceased trading and had sold its assets to its parent company at book value, but payment was made by way of a set-off against a debt due to the parent company. There was no suggestion that the price paid was other than a proper one or that the subsidiary's indebtedness to the parent company was otherwise than *bona fide* incurred in the course of trade. The liquidator alleged that the subsidiary's business was carried on fraudulently because the parent company, well knowing that the subsidiary was unable to pay its debts in full, caused the assets of the subsidiary to be distributed amongst creditors other than the Italian company, and mainly to the parent company itself.

Striking out the points of the liquidator's claim, Oliver J. said:

"What is alleged here - and it is all that the liquidator relies upon - is the bare fact of preference and in the light of the authorities to which I have referred the proposition that, *per se*, constitutes fraud within the meaning of the section is

64. [1979] 1 Ch. 592.

not one which is, in my judgement, arguable with any prospect of success."⁶⁵

It is, in fact, difficult to reconcile Re Gerald Cooper Chemicals Ltd. with Re Sarflax. In the former case, it was held that an external creditor is a party to the carrying on of the company's business with intent to defraud when he is knowingly repaid from funds fraudulently obtained by other creditors. In the latter case, it was held that there is no fraudulent intent when a parent company obtains repayment from its subsidiary to the detriment of a subsidiary's external creditor.

The difference between the two cases lies in the fact that, whereas in Re Gerald Cooper Chemicals Ltd. the creditor was allegedly aware that the funds were fraudulently obtained, in Re Sarflax there was no fraud to which the parent might have been a party. Oliver J. insinuated that his conclusion would be different if there was any suggestion that the indebtedness of the subsidiary to the parent company was not genuine or *bona fide* or that the realisation of the subsidiary's assets was improper⁶⁶.

Hence, even where the parent company may validly be considered a party to the carrying on of the subsidiary's business, it is very difficult to establish that it was a party to a fraud. It seems, therefore, that the requirement to prove fraudulent intent accounts for the inapplicability of the provision in circumstances where, although no fraud can be established, the interests of the creditors of an insolvent subsidiary are greatly prejudiced, like in Re Sarflax. As it is pointed out by Professor Prentice, the "strict standard for proving fraud greatly attenuates the effectiveness of the section as a means of providing an insolvent subsidiary's creditors with access to the parent's assets"⁶⁷.

65. *Ibid.*, at 612.

66. *Ibid.*, at 609.

67. D.D. PRENTICE, *Groups of Companies: The English Experience*, in K. HOPT (ed.), *Groups of Companies in European Laws, Legal and Economic Analyses on Multinational Enterprises* (1982), vol. ii, p. 99 at 110.

iii) Wrongful trading

a. The provision

Commenting on the fraudulent trading provision, Professor Goode considers that "[t]he burden of establishing fraud to the standard of proof required by the criminal law ... proved a serious deterrent to the institution of proceedings, and the statutory provisions became almost, though not quite, a dead letter."⁶⁸

For this reason, the Jenkins Committee recommended that the provision should not only cover cases of fraudulent trading but, also, cases where a company's affairs have been carried out in a reckless manner⁶⁹. The recommendation of the Jenkins Committee was given effect only twenty five years later in the form of the provision on wrongful trading of I.A. 1986, s. 214, after similar recommendations made by the Cork Committee⁷⁰.

The Cork Committee felt that, under the fraudulent trading provision, "the difficulty of establishing dishonesty has deterred the issue of proceedings in many cases where a strong case has existed for recovering compensation from the directors or others involved"⁷¹. Accordingly, it proposed the introduction of the wrongful trading provision because "a climate should exist in which downright irresponsibility is discouraged and in which those who abuse the privilege of limited liability can be made personally liable for the consequences of their own conduct"⁷². The Committee thought that the wrongful trading provision would strike a balance between the need for economic growth and the need to discourage abuse of the privilege of limited liability⁷³.

68. R.M. GOODE, *op. cit.*, p. 203.

69. Report of the Committee on Company Law Reform (1962), *op. cit.*

70. "We recommend that the whole of section 332 [the former fraudulent trading provision] should be repealed so far it provides a civil remedy, and that it should be replaced by an entirely new section under which civil personal liability can arise:

(a) without proof of fraud or dishonesty; and
(b) without requiring the criminal standard of proof."

Insolvency Law Review Committee (1982), *op. cit.*, at para. 1778.

71. *Ibid.*, at para. 1776.

72. *Ibid.*, at para. 1805. "The doctrine of limited liability may have its good points, but it also leads to some indifference and lack of concern when company officials know that if the company goes down, they will not have any financial liability." Extract from written evidence submitted by a Divisional Consumer Protection Officer of the South Yorkshire County Council, *ibid.*, at para. 1741.

73. *Ibid.*

It thus appears that the provisions on fraudulent and wrongful trading have the same underlying *ratio* and the same objective. They both emerged as a result of the concern for the abuses of limited liability and they aim at the protection of creditors. Because it was felt that fraudulent trading is subject to very strict requirements, the wrongful trading provision with a much wider scope was introduced. According to the wrongful trading provision, personal liability may be imposed not only on those persons who acted dishonestly towards the company's creditors, but also on those who, in one way or another, have simply disregarded the creditors' interests.

The crucial difference between the provisions on fraudulent and wrongful trading lies, therefore, in the degree of culpability which is required to be proved against the respondent⁷⁴. Section 213 requires intent to defraud or, as it has been usually interpreted, actual dishonesty, moral blame. On the contrary, section 214 on wrongful trading follows the recommendation of the Cork Committee:

"It is right that it should be an offence to carry on a business fraudulently; and right that, in the absence of dishonesty, no offence should be committed. Where, however, what is in question is not the punishment of an offender, but a provision of a civil remedy for those who have suffered financial loss, a requirement that dishonesty be proved is inappropriate. Compensation ought, in our view to be available to those who suffer foreseeable loss as a result, not only of fraudulent, but also of unreasonable, behaviour."⁷⁵

b. The requirements

The provision is applicable in circumstances where:

- i) the company has gone into insolvent liquidation⁷⁶,
- ii) at some time before the commencement of the winding up of the company, a person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation⁷⁷,
- iii) that person was a director or a shadow director of the company at that time⁷⁸, and

74. "The real distinction between an application for a contribution based on the respondent's fraudulent trading and the respondent's conduct under s. 214, lies in the fact that in the latter case the respondent's conduct falls to be judged, in part at least, by an objective standard of what is reasonable." H. RAJAK, *Company Liquidations*, 1988, p. 313. For a list of the differences between wrongful and fraudulent trading, see R. GOODE, *op. cit.*, pp. 203-204.

75. *Op. cit.*, at para. 1777.

76. *Insolvency Act 1986*, s. 214 (2)(a); s. 214 (6) provides that a company goes into insolvent liquidation if liquidation occurs at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up.

77. *Ibid.*, s. 214 (2)(b).

78. *Ibid.*, s. 214 (1), (7).

iv) that director fails to establish that he took every step that he ought to have taken to minimize the potential loss to the company's creditors after he first realized or he should have concluded that the company would not avoid going into insolvent liquidation⁷⁹.

If all the four requirements of the provision are satisfied, the court may declare that the director is liable to make such contribution to the company's assets as the court thinks proper. The liability imposed is not a direct one since the director cannot be declared liable to compensate a particular creditor⁸⁰.

The nature and the extent of the contribution order was the issue under discussion in Re Produce Marketing Consortium Ltd⁸¹. According to the view supported by the counsel for the defendant directors, the nature of the provision is penal and, therefore, the amount of the contribution ordered should reflect the degree of the director's culpability⁸². However, Knox J. adopted the view that the nature of the provision is primarily compensatory and "the appropriate amount that a director was to be declared liable to contribute was the amount by which the company's assets could be seen to have been depleted by the director's conduct which caused the discretion under the section to arise"⁸³.

79. *Ibid.*, s. 214 (3).

80. In contrast, the Irish Companies (Amendment Act) 1990, in section 33, gives the court discretion to decide whether it will order a contribution to the company's assets or it will order the sums to be paid directly to the person who suffered the loss. Section 33(1)(a) provides as follows:

"If in the course of proceedings under this Act it appears that any person was, while an officer of the company, knowingly a party to the carrying on of any business of the company in a reckless manner, the court, on the application of the examiner, or any creditor or contributory of the company, may, if it thinks it proper to do so, declare that such person shall be personally responsible, without any limitation of liability, for all or any part of the debts or other liabilities of the company as the court may direct."

See L. FLYNN, Quasi-Criminal Law, Fraudulent, Reckless and Wrongful Trading, paper presented in W. G. Hart Legal Workshop 1991 on Insolvency, IALS, p. 15.

81. [1989] 5 B.C.C. 569.

82. See J. DINE, Quasi-Criminal Law, Fraudulent, Reckless and Wrongful Trading, paper presented in W. G. Hart Legal Workshop 1991 on Insolvency, IALS, where she concludes (at p. 27) that "[t]he measures [of fraudulent and wrongful trading] were intended by Parliament to have penal functions and many judges have recognised penal elements flowing from the sections although the recognition may have been instinctive rather than as a result of analysis".

83. *Op. cit.*, at 570. Also, in Re Purpoint (see below), ChD [1991] BCC 121 at 128-129, Vinelott J. held:

"The court in making an order under s. 214, is concerned to ensure that any depletion in the assets of the company attributable to the period after the moment when the directors knew or ought to have known that there was no reasonable prospect of avoiding an insolvent winding-up - in effect, while the company's business was being carried on at the risk of creditors - is made good ... The purpose is to recoup the loss to the company so as to benefit the creditors as a whole."

1. Degree of culpability

Subsections (2)(b) and (3) in combination with subsection (4) of s. 214 of the Insolvency Act 1986 lay down the degree of culpability that triggers liability for wrongful trading and the degree of diligence that may be opposed to the attachment of liability, as a statutory defence.

A person may be held liable, if, at some time before the commencement of the winding up, while a director or a shadow director, he knew or ought to have concluded that there was no reasonable prospect of the company avoiding going into insolvent liquidation⁸⁴. But he can avoid liability if he can establish that after he first realised or should have concluded that the company would inevitably go into insolvent liquidation, he took every step that he ought to have taken to minimize the potential loss to the company's creditors⁸⁵.

In determining, first, whether the director knew or ought to have concluded the inevitability of the insolvent liquidation and subsequently, whether he took every step that he ought to have taken to minimize the loss to the creditors, two criteria are used: i) the degree of knowledge, skill and experience which can be reasonably expected from a person carrying out the same functions in relation to the company as the respondent, and ii) any general knowledge, skill and experience possessed by the respondent, in particular⁸⁶.

As a matter of interpretation, resort to the second criterion can be made only when the respondent's own knowledge, expertise and experience is superior to that normally expected from a person in his position⁸⁷. Therefore, a director cannot avoid being held liable for wrongful trading by establishing that he lacks the knowledge, skill and experience normally expected from a person carrying out the same functions with him. Likewise, a director cannot avoid liability by establishing that he exercised the knowledge, skill and experience normally expected from a person carrying out the same functions with him, when, due to his own superior abilities he could attain a better standard of performance.

In Re Produce Marketing Consortium Ltd⁸⁸, one of the issues discussed was whether at some time before the company went into insolvent liquidation, the two directors of the company knew

84. Insolvency Act 1986, s. 214 (2)(b).

85. Ibid., s. 214 (3).

86. Ibid., s. 214 (4).

87. R.R. PENNINGTON, op. cit., p. 45; H. RAJAK, op. cit., p. 314; Cork Report, op. cit., paras. 1789, 1790.

88. Op. cit.

or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation. Analysing the standards postulated by subsection (4), Knox J. said:

"... the requirement to have regard to the functions to be carried out by the director in question, in relation to the company in question, involves having regard to the particular company and its business. It follows that the general knowledge, skill and experience postulated will be much less extensive in a small company in a modest way of business, with simple accounting procedures and equipment, than it will be in a large company with sophisticated procedures."⁸⁹

He further argued that:

"The knowledge to be imputed in testing whether or not directors knew or ought to have concluded that there was no reasonable prospect of the company avoiding insolvent liquidation is not limited to the documentary material actually available at the given time ... [T]here is to be included by way of factual information not only what was actually there but what, given reasonable diligence and an appropriate level of general knowledge, skill and experience, was ascertainable."⁹⁰

Accordingly, the two directors who continued to carry on the company's business and to incur further liabilities at a time when the company was virtually insolvent but its insolvency had not yet been revealed, were held liable for wrongful trading. The judge concluded that the directors "had a close and intimate knowledge of the business and they had a shrewd idea whether the turnover was up or down"⁹¹.

Referring to the question whether the directors took every step with a view to minimizing the potential loss to the company's creditors, the judge said that it had "clearly ... to be answered "No", since they went on trading for another year"⁹² in a way which was found to be far from limited to the satisfaction of the requirement of s. 214 (3). In addition, the main creditors

89. *Ibid.*, at 594-595.

90. *Ibid.*, at p. 595.

91. *Ibid.*, at p. 595.

92. *Ibid.*, at 596.

"were not told, as they should have been, what the true financial picture was so as to be given the opportunity of deciding for themselves what to do"⁹³.

In Re DKG Contractors Ltd.⁹⁴, the liquidator of a company sought, *inter alia*, to hold the company's only two directors liable under s. 214 of the IA, in order to recover sums paid to one of them at a time when the company was in apparent financial difficulty. Upholding the liquidator's claim, John Weeks QC said:

"... directors are judged not only by their own knowledge and skill and experience, but also by the knowledge, skill and experience that directors in their position could reasonably be expected to have. Patently, Mr and Mrs Gibbons' [the company's only two directors who together held 98 of its 100 shares] own knowledge, skill and experience were hopelessly inadequate for the task they undertook. That is not sufficient to protect them."⁹⁵

In Re Purpoint⁹⁶, a case concerning, *inter alia*, an application by the liquidator under s. 214 against a former director of the company, Vinelott J. felt some doubt whether a reasonably prudent director would have allowed the company to commence trading at all. However, he concluded that it would not be right to consider that the respondent "ought to have known that the company was doomed to end in an insolvent winding up from the moment it started to trade". That, he argued, would impose "too high a test"⁹⁷. Holding, nevertheless, the respondent liable for wrongful trading, he said:

"On the other hand, in my judgement, it should have been plain to Mr Meredith [the respondent] by the end of 1986 [the company started trading in February 1986] that the company could not avoid going into insolvent liquidation. The company could not meet its trade debts as they fell due. In addition, it owed very large Crown debts and it had no prospect whatever that it could turn its trading into profit sufficiently quickly to pay them off."⁹⁸

These decisions show that directors may be held liable for wrongful trading even though there is no suspicion of dishonesty; it is sufficient to prove that a director acted unreasonably. The

93. *Ibid.*

94. [1990] B.C.C., 903.

95. *Ibid.*, at 912.

96. *Op. cit.*

97. *Ibid.*, at 127.

98. *Ibid.*, at 127-128.

standard of performance required of directors is a high one: notwithstanding that their skills and abilities may be inadequate for the task they undertook, they should always be aware of the actual financial condition of the company, and once the company faces serious financial difficulties, they should act reasonably with a view to the interests of the company's creditors.

2. Persons covered: applicability to parent-subsidary

In its proposed draft clause, the Cork Committee did not differentiate between fraudulent and wrongful trading as far as the status of the respondent was concerned⁹⁹. According to art. 3 of the draft clause "any person party to the carrying on of the business of the company" could be held personally liable. Thus, the Committee intended that the new provision would cover any such person, whether or not he was an officer of the company:

"The accountant, auditor or banker, for example, who may advise against any further trading but whose acts are unreflected in the carrying on of the offending business cannot be liable, however much any of them may know of its commercial insolvency or of the hopelessness of its position. An auditor who actively assists in the concealment of the facts which constitute wrongful trading may, however, thereby make himself party to it."¹⁰⁰

However, this recommendation of the Committee was not followed; according to s. 214 of the Insolvency Act 1986, liability for wrongful trading may be imposed only on a person lawfully appointed to the board of the company as a director or on a person in accordance with whose instructions or directions the directors of the company are accustomed to act, namely a shadow director¹⁰¹.

Thus, a controlling shareholder, like the parent company, falls within the scope of the wrongful trading provision only if it is regularly involved in the management of the subsidiary by virtue of giving directions or instructions to which the subsidiary's directors are accustomed to submit. In the absence of regular interference with the subsidiary's management, the parent cannot be held liable for wrongful trading merely because it is in a position to appoint the majority of the members of the subsidiary's board¹⁰².

99. *Op. cit.*, at para. 1806.

100. *Ibid.*, at para. 1787.

101. See Companies Act 1985, s. 741; also, Insolvency Act 1986, s. 251.

102. However, the Cork Committee (*op. cit.*, at para. 1938) suggested that in the group context, "it will often be impossible to determine whether instructions have been given to the board of the subsidiary or other means used to secure its compliance with the wishes of the parent". Accordingly, the Committee proposed that the parent company should be rebuttably presumed to be a

Thus, the term "person knowingly party to the carrying on of the business of the company", which is used in the fraudulent trading provision, is in one sense broader and in another sense narrower than the term "director or shadow director" which is used in the wrongful trading provision. The former covers a parent company which instructed the subsidiary to enter a particular transaction without necessarily being its director or a shadow director; it requires, however, active and specific participation and not merely a custom to advise or to instruct the subsidiary's directors.

For instance, it was at least arguable in the Re Augustus Barnett case¹⁰³, that the parent company was a party to the carrying on of the subsidiary's business by virtue of producing statements of support for the subsidiary, although the court did not have to decide on the issue. It would be, however, very difficult to establish that, by merely producing such statements, the parent company became the shadow director of its subsidiary and fell within the scope of the wrongful trading provision¹⁰⁴.

Also, according to the decision in Re Gerald Cooper Chemicals Ltd¹⁰⁵, a parent company may be considered a party to the carrying on of its subsidiary business, if, as a creditor of its subsidiary, presses for repayment of loans out of funds fraudulently obtained by other creditors. However, this behaviour does not suffice to render the parent company the shadow director of the subsidiary. It should, additionally, be shown that the parent company has a substantial and regular interference with the subsidiary's management, e.g. it dictates what cheques should be paid, what parts of the subsidiary's business should be sold or what policies should be adopted¹⁰⁶.

In Re a Company (No 005009 of 1987)¹⁰⁷, the company was trading profitably until it lost its major customer. The company's bank appointed inspectors to report on the company's position and, as a result of the report, it took a debenture. The company was also required by the bank to implement several recommendations contained in the report. All the proceeds of

party to the decisions of the subsidiary's management wherever the parent has been responsible for the appointment of the subsidiary's board or a substantial part thereof, or where the boards of the two companies consist of substantially the same persons.

103. Op. cit.

104. It is argued, however, that if the requirement of the fraudulent trading provision that the person must have been party to the carrying on of the company's business is satisfied, "this would obviously be enough to make a person a shadow director and thus potentially liable for wrongful trading". D.D. PRENTICE, *Fraudulent Trading: Parent Company's Liability for the Debts of its Subsidiary*, 103 L.Q.R. 1987, p. 11 at 14.

105. Op. cit.

106. See R.M. GOODE, op. cit., p. 206.

107. (1988) B.C.C., p. 424.

the company's trading were paid into a special account operated by the bank and drawings were made only with the bank's consent. In view of these facts, Knox J. refused to strike out the claim that the bank acted as a shadow director because it was not "obviously unsustainable"¹⁰⁸.

Despite the preliminary character of the judgement and the fact that during the trial the liquidator abandoned the wrongful trading claim¹⁰⁹, this case indicates that the possibility of holding a parent company liable for wrongful trading is not so remote, especially when the parent, being a secured lender, extensively interferes with the affairs of a financially troubled subsidiary.

The wrongful trading provision is not only applicable in cases of active trading, e.g. in cases where further credit is obtained and further liabilities are incurred although the company is already insolvent. What may alone trigger application of the provision is a failure to act with a view to creditors' interests. Thus, cases of no trading such as depletion of the subsidiary's assets by the payment of excessive management fees to the parent¹¹⁰ or of suspension of trading¹¹¹ may come under section 214 in spite of the inclusion of the term "trading" in the title to the provision.

Therefore, a parent company cannot escape liability for wrongful trading by closing down a subsidiary after it realized or ought to have realized that the subsidiary would not avoid going into insolvent liquidation, unless the parent succeeds in establishing that it did so in order to minimize the potential loss to the subsidiary's creditors¹¹².

As in the case of fraudulent trading, the court has discretion to charge the amount of the contribution ordered on any debt or obligation due from the company to the director and may also subordinate the whole or any part of any debt owed to the director to all other debts owed by the company¹¹³. Accordingly, if the court considers that the parent company which

108. *Ibid.*, at 431.

109. *Re M. C. Bacon Ltd.*, [1990] B.C.C. 78, at 79.

110. *H. RAJAK*, *op. cit.*, p. 313.

111. *R.M. GOODE*, *op. cit.*, pp. 204-205, 209.

112. *In Re Sarflax*, (*op. cit.*, at 593), a case on fraudulent trading involving a parent company which bought the assets of its subsidiary by way of set-off against a debt owed by the subsidiary to the parent, it was held that the expression "carrying on any business" was not necessarily synonymous with actively carrying on trade. Accordingly, "the collection of assets acquired in the course of business and the distribution of the proceeds thereof in payment of debts could constitute the carrying on of any business".

113. *Insolvency Act 1986*, s. 215 (2), (4).

advanced credit to its subsidiary, acted as its shadow director, it may charge the amount of the contribution ordered on any debt owed by the subsidiary to the parent. Alternatively, the court may ignore any sort of priority that the parent as a secured creditor of the subsidiary is expected to have, and subordinate its claim against the subsidiary to the claims of all the other creditors of the subsidiary.

c. A critical assessment

Section 214 in combination with section 215 of the Insolvency Act 1986 constitutes a significant step towards a more comprehensive protection of the creditors' interests. Professor Prentice considers that this development "is unquestionably one of the most important developments in company law this century" since "the threat to directors that they will be made personally liable for the debts of a company which has continued to trade at the expense of its creditors has significantly eroded the principle of limited liability"¹¹⁴.

Insofar as groups of companies are concerned, it is suggested that the wrongful trading provision generates a "distinct possibility that liquidators will be able, in an appropriate case, to ensure that a parent company is made liable for the debts of its subsidiary"¹¹⁵. The fact that the wrongful trading provision covers shadow directors makes it more likely that cases of misconduct within groups of companies will be caught.

Under the threat of liability for wrongful trading, parent companies should take care to avoid mismanaging their subsidiaries. It is for the best interests of parent companies to take reasonable steps to ensure that subsidiaries are not managed to the detriment of their creditors. In particular, parent companies should avoid encumbering a subsidiary with further liabilities when there is a minimal chance that the subsidiary will ever be able to meet them. Moreover, parent companies should seriously consider whether the proper course of action in order to avoid liability for wrongful trading is to cause the subsidiary to be wound up immediately after they realize its insolvency.

However, due to the conditions that is subjected to, it is unlikely that the provision will bring the expected radical change. As with fraudulent trading, applications can only be made once the company is in liquidation. That means that a creditor who seeks to make the directors liable for his losses to an insolvent company has to incur significant costs and inconvenience in putting

114. D.D. PRENTICE, *Creditors' Interests and Directors' Duties*, Ox. J. L. S., 1990, p. 265 at 277. See also D.J. COOKE, *Limited Liability Abolished*, 4 *Insolvency Law & Practice*, 1988, p. 157.

115. A. WILKINSON, *Piercing the Corporate Veil and the Insolvency Act 1986*, 8 *Co. Law*. (1987), p. 124 at 127.

the company into liquidation. Also, although there is no requirement to establish intent to defraud, there are not yet definite guidelines as to what constitutes a conduct for which a director can be held liable¹¹⁶. The use of a vague term such as "no reasonable prospect" renders the provision vulnerable to various and contradictory interpretations¹¹⁷. There is also the question of the nature of the provision which affects the extent of the contribution that the court may order. When all these factors are taken into consideration, it seems, as Rajak points out, that "the chances of this section doing what the Cork Committee recommended are negligible"¹¹⁸.

It is also unlikely that a parent company will be held liable to make a contribution to its subsidiary's assets under s. 214. The circumstances in which a parent company is deemed to be the shadow director of its subsidiary have not yet been clarified either by statute or by the courts¹¹⁹. Also, it should be borne in mind that the typical group does not consist only of one parent and one subsidiary. It is a highly complex structure which can change shape according to the groups' interests¹²⁰. Thus, even when the interpretative problems of the provision are solved, a group will be able to minimize the effect of an order imposing contribution under s. 214 on one of its companies, by separating those companies which act as shadow directors for the others from those companies which concentrate the greatest pool of assets within the group. The financial and organizational structure of the group may be such that the member of the group which is considered to be the shadow director of the insolvent member, has assets so insignificant that, even if they are made available to creditors under 214, they will not be enough to satisfy them.

The wrongful trading provision is likely to provide a satisfactory means of protection to creditors of a subsidiary only if two additional issues are resolved:

a) the clarification of the circumstances where a parent company can be considered a shadow director of its subsidiary, and

116. The Institute of Directors has issued Guidelines to Board Room Practice for Companies in Financial Difficulties mainly in order to guide the responsible directors to avoid liability for wrongful trading. See *Company Directors and Wrongful Trading*, *Bus. L. Rev.*, March 1991, p. 78.

117. See FIDELIS ODITAH, *Wrongful Trading*, *Ll. M. C. L. Qu.*, 1990, p. 205 at 207-211.

118. H. RAJAK, *op. cit.*, p. 315.

119. It is pointed out (A.J. BOYLE & R.C. SYKES, *Gore - Browne on Companies*, 44th ed., 1986, vol. II, *supp.* 12, p. 35021) that s. 214 "raises in probably its most acute form the uncertainty inherent in the definition of a "shadow director"; it is also predicted (J.H. FARRAR, N.E. FUREY, B.M. HANNIGAN, *op. cit.*, p. 717, *fn.* 19) that there is likely to be much litigation on the issue.

120. *Supra*, ch. III, B, ii, a.

b) the consideration of whether it would be appropriate, in certain cases, to render liable for wrongful trading not only the company of the group which acted as a shadow director of the insolvent subsidiary, but the group as a whole with all its assets.

C. CONCLUSION

In English statutory law, the group of companies is not yet recognized as an object of separate legislation. With the exception of the definitions of the parent-subsidary relationship, the other relevant provisions are merely extensions of provisions which are primarily applicable in the context of the single company. It is significant, however, that these provisions inherently accept that the parent with its subsidiaries form a single economic unit.

Nevertheless, the principle is that the parent, as a separate legal entity, has only limited liability for the debts of its subsidiary. Exceptionally, a parent company may become liable for the debts of its subsidiary by virtue of three provisions. These provisions are not specifically applicable to the parent-subsidary context. Because they are drafted so as to cover not only natural but, also, legal persons as respondents, liability may be imposed on the parent company when certain requirements are satisfied.

The first of these provisions (CA s. 24), according to which liability may be imposed on the parent as the sole member of a public wholly-owned subsidiary, has no practical importance because of the improbability that it will ever be invoked.

The application of the provisions on fraudulent and wrongful trading in the context of the parent-subsidary relationship relies upon evidence indicating that the parent company exercises some degree of managerial control over its subsidiary. The limited liability of the parent is abrogated either where the parent was knowingly party to the carrying on of its subsidiary's business with intent to defraud creditors (IA s. 213 on fraudulent trading) or where the parent was the director or the shadow director of its insolvent subsidiary (IA s. 214 on wrongful trading).

Insofar as these provisions link the managerial control exercised by the parent over its subsidiary with the abrogation of the limited liability of the parent, they are in the right direction. However, in addition to the fact that the provisions may only be invoked in the winding up of the company, they suffer from a number of drawbacks which make it very

difficult to cover the majority of the cases where the parent is engaged in the subsidiary's management by misusing or abusing the limited liability rule.

Section 213 of IA 1986 on fraudulent trading, although it covers almost all the circumstances in which a parent is engaged in the management of its subsidiary, is subject to the very strict requirement of establishing intent to defraud.

Section 214 of IA 1986 on wrongful trading, although it is free from the evidential difficulties of s. 213, applies only in circumstances where the parent company is found to be the shadow director of its subsidiary and its significance can be minimized by the internal organization of the group.

Hence, due to their inherent limitations, neither of these provisions can effectively constitute a general rule of attaching liability for the debts of a subsidiary to its parent company which exercises managerial control over the subsidiary's affairs. The interests of the subsidiary's creditors would be better served by a rule which should have the following characteristics:

1. It should not only apply in the event of the subsidiary's winding up.
2. It should not use terms which need a great deal of clarification such as "party to the carrying on of the business" and "shadow director".
3. It should not be subject to requirements as to the state of mind of those in control of the company, such as the "intent to defraud" requirement.
4. It should not be easily evaded by the internal organization and arrangements of the group.

CHAPTER VIII: GROUPS OF COMPANIES IN CONTINENTAL LAWS

Paragraph 8 of the introduction to the 1976 OECD Guidelines for Multinational Enterprises¹ lays down that "the guidelines are addressed to the various entities within the multinational enterprise (parent companies and/or local entities) according to the actual distribution of responsibilities among them on the understanding that they will co-operate and provide assistance to one another as necessary to facilitate observance of the guidelines".

In its report on the Badger case², the OECD Committee on International Investment and Multinational Enterprises (IME Committee), analysed paragraph 8 and considered that the financial responsibility of a parent company for a subsidiary, "as a matter of good management practice - in light of such factors as e.g. aspects of the relationship between the parent company and the subsidiary and the conduct of the parent company - consistent with the observance of the Guidelines, could arise in special circumstances"³.

Hence, despite the fact that the observance of the Guidelines is voluntary and not legally enforceable⁴, Member States of the OECD are encouraged to deviate from the principle of limited liability, as it applies in groups of companies, in order to protect the interests of third parties. However, this step was not taken by English law.

Although the English company law sometimes recognizes and gives to the operation of the group as a single economic unit and especially to the exercise of managerial control by the parent over its subsidiary, the principle of limited liability remains as strict as ever. In almost all the English cases where the separate personalities of parent and subsidiaries were not

1. Annex to the Declaration of 21 June, 1976 by Governments of OECD Member Countries on International Investment and Multinational Enterprises, Guidelines for Multinational Enterprises.

2. See *supra*, ch. IV, A, iii, c.

3. R. BLANPAIN, *The OECD Guidelines for Multinational Enterprises and Labour Relations 1976-1979*, 1979, pp. 142-143.

4. R. BLANPAIN (ed.), *International Encyclopedia for Labour Law and Industrial Relations*, vol. I, supp. 47 (January 1985), Guidelines I, p. 30.

respected, the issue under adjudication has been other than the liability of the parent company for the debts of its subsidiary⁵. In the statutes, liability may be imposed on the parent company for the debts of its subsidiary under the provisions on fraudulent and wrongful trading. However, these provisions are subject to very strict requirements and can be invoked at a very late stage⁶.

In Continental laws, like in the laws of the United States⁷, the linkage between the parent's managerial control and the parent's liability for the subsidiary's debts finds a greater deal of support. There is a discernable tendency of abrogating the rule of limited liability and imposing liability on the parent company in certain circumstances. When the solutions proposed or given by the Continental laws are combined with the conclusions derived from the examination of the relevant English law, it may become possible to formulate a satisfactory group liability rule.

A: THE GERMAN APPROACH

Unlike most other legal systems, German law has a specific set of rules applicable to groups of companies. These rules are contained in the *Aktiengesetz* (Stock Corporation Act) of 1965, in articles 15-19, which define the different forms of enterprise connection and in articles 291-337, which contain the substantive provisions. These articles constitute what is called *Konzernrecht*, i.e. the law of groups.

Whereas the definitions are valid for all companies regardless of their legal form⁸, the substantive provisions are only applicable where one of the companies, usually the subsidiary, either as a dependent or an integrated company, is a stock corporation (*Aktiengesellschaft AG*)⁹ or a partnership limited by shares (*Kommanditgesellschaft auf Aktien, KGaA*).

However, in Germany, the most popular corporate form is the *Gesellschaft mit beschränkter Haftung* (GmbH), a form which has similarities with the English private company but, unlike

5. See *supra*, ch. VI, C.

6. See *supra*, ch. VII, B, ii and iii.

7. See *supra*, ch. VI, D.

8. *Süssen*, 80 BGHZ 69, 72-74 (1981); H. WIEDEMANN, *The German Experience with the Law of Affiliated Enterprises*, in K. HOPT (ed.), *Groups of Companies in European Laws, Legal and Economic Analyses on Multinational Enterprises* (1982), vol. ii, p. 21 at 39.

9. The strict English equivalent of this form of corporation (AG) is the registered public company limited by shares.

it, is the subject of separate legislation¹⁰. It is estimated¹¹ that, by the end of 1988, there were only 2,373 AG as compared with about 400,000 GmbH and probably more than 60,000 GmbH & Co¹². To cope with the reality of the groups consisting of subsidiaries of the latter two forms, the courts tend to apply the *Konzernrecht* to such groups by way of analogy¹³.

i) Definitions

The central concept of the German regulation of groups is the concept of the dependent enterprise. An enterprise is deemed to be dependent on another enterprise when this other enterprise is able to exert, directly or indirectly, a controlling influence over it¹⁴.

It is presumed that an enterprise, the majority of the shares of which are held by another enterprise, is dependent on that other enterprise¹⁵. That enterprise may rebut this presumption, especially if it has agreed to abstain from exercising its voting rights at the meetings of the majority-owned enterprise or the shares held confer only limited voting rights and it can prove that it is unable to exercise controlling influence in any other manner¹⁶.

A group is formed either when a controlling and one or more dependent enterprises are combined under the uniform management of the controlling enterprise (vertical group)¹⁷ or when enterprises which are legally and factually independent of each other come under uniform management (horizontal group)¹⁸. It is presumed that a dependent enterprise forms a group with the controlling enterprise¹⁹.

10. For the nature and history of the GmbH, see B.W. MEISTER, *The Limited Liability Company*, in B. RUSTER (ed.), *Business Transactions in Germany*, 1992, vol. II, ch. 23, pp. 8-13.

11. K.J. HOPT, *Legal Elements and Policy Decisions in Regulating Groups of Companies*, in CL. SCHMITTHOFF & FR. WOOLDRIDGE (ed.), *Groups of Companies*, 1991, p. 81 at 82.

12. This is a typically German legal hybrid between the GmbH and a limited commercial partnership; see B.W. MEISTER, *op. cit.*, at 14-15.

13. See below, under iii.

14. AktG art. 17 (1).

15. AktG, art. 17 (2).

16. M. SCHIESSL, *The Liability of Corporations and Shareholders for the Capitalization and Obligations of Subsidiaries under German Law*, (1987) *Nw. J. Int'l L. & Bus.*, p. 480 at 496; FR. WOOLDRIDGE, *Groups of Companies: The Law and Practice in Britain, France and Germany* (hereinafter cited as FR. WOOLDRIDGE I), 1981, p. 49.

17. AktG, art. 18 (1).

18. AktG, art. 18 (2).

19. AktG 18 (1), sent. 3.

The concepts of controlling influence and uniform management are not defined in the statute and it is left to the courts and the scholars to define them. In general, it is considered that an enterprise is in a position to exercise a controlling influence if it has the means of making another enterprise comply with its wishes; the methods used for this purpose are irrelevant²⁰. The controlling influence may be capable of being exercised either by means of a major participation in the dependent enterprise or by means of a control contract or by means of the power to control the composition of the management board of the dependent enterprise or by means of the fact that the boards of both enterprises are essentially composed of the same persons²¹.

However, it is considered that a position to exercise a controlling influence cannot arise from purely economic circumstances, such as the actual influence which a bank can exercise on the policy of a heavily indebted company. Only if this economic control is reinforced by the influential position of the bank as a major shareholder or by its power to secure the appointment of managers of its choice, can the bank be considered in a position to exercise controlling influence over the company²².

Uniform management is deemed to be exercised when two enterprises are party to a control contract²³ or the one is integrated into the other²⁴. In the absence of a control contract or integration, it is generally agreed that a dependent enterprise may be under the uniform management of the controlling enterprise even though the latter does not determine all the decisions taken by the former. It suffices that the controlling enterprise establishes general guidelines for the dependent enterprise, and it determines the business and the financial policy of the dependent enterprise²⁵.

20. *Thega*, RGZ 167, 49.

21. FR. WOOLDRIDGE, *Aspects of the Regulation of Groups of Companies in European Laws* (hereinafter cited as FR. WOOLDRIDGE II), in R.R. DRURY and P.G. XUEREB (ed.), *European Company Laws*, 1990, p. 103 at 109.

22. See *BuM/WestLB* (1984), 90 BGHZ 381, 394, where it was held that economic dependency is not sufficient for legal dependency under art. 17 of AktG and that a bank is not in a position to exercise a controlling influence even though the corporation is dependent on its credit; K.J. HOPT, *op. cit.*, p. 93.

23. See below, ii, b.

24. See below, ii, a.

25. FR. WOOLDRIDGE I, *op. cit.*, p. 52. In pp. 52-53, fn. 94, another view (GESSLER, *Kommentar zum Aktiengesetz*, 1975, Vol.1, pp. 240-243) is quoted according to which uniform management may be said to exist where the investment, personnel, marketing or financial policy to be followed by the dependent enterprise is determined at the level of the controlling enterprise; and where the controlling enterprise is able to make its wishes prevail in connection with at least one of these policies because certain of its directors are also directors of the dependent enterprise, or because it controls a majority of the votes at the general meeting of the dependent enterprise.

Hence, in German law, an enterprise may be said to be dependent on another when this other is in a position to exercise a controlling influence; the establishment of controlling influence is based on formal criteria such as a majority shareholding and the power to appoint the majority of the dependent enterprise's directors. However, once the controlling-dependent relationship is established, a vertical group may be said to be formed on the basis of a pure economic criterion, i.e. the actual exercise of uniform managerial control by the controlling enterprise.

The economic criterion of uniform managerial control retains its significance in the provisions dealing with the liability of the controlling enterprise for the obligations of the dependent. In these provisions, the imposition of liability on the controlling enterprise either proceeds on the assumption that the controlling enterprise exercises uniform managerial control or it is based on evidence indicating so.

ii) Substantive provisions

a. Integrated groups (319-327 AktG)

Where an enterprise holds between 95 and 100 per cent of the shares of another enterprise, the two enterprises can agree to integrate formally by resolution of their shareholders' meetings²⁶. Upon entering the integration on the trade register, all the remaining shares of the integrated enterprise pass over to the principal enterprise by operation of law, and the outside shareholders, if there are any, must be compensated either with shares of the principal enterprise or in cash²⁷.

Integration is the closest form of corporate affiliation in Germany. The integrated enterprise and the enterprise with which it integrates (the principal enterprise) form a group because they are deemed to be under uniform management²⁸. Upon integration, the principal enterprise essentially acquires unlimited power to direct the integrated enterprise notwithstanding that the directions may be to the latter's detriment²⁹. The principal enterprise acquires also the unrestricted right to dispose of the assets of the integrated enterprise as though they were its own³⁰. As a corollary of this authority, the principal enterprise is liable to the creditors of

26. AktG, arts. 319, 320.

27. AktG, art. 320 (4) and (5).

28. AktG, art. 18 (1).

29. AktG, art. 323 (1).

30. AktG, art. 323 (2).

the integrated enterprise, jointly and severally with the latter, for all its debts and liabilities incurred both before and after integration took place³¹.

The principal reasons for which two enterprises may wish to integrate is the preferential tax treatment and the maintenance of the goodwill of the integrated enterprises³². In fact, integration comes close to a merger between two companies without unifying them. The separate legal personalities of the integrated enterprises are not destroyed and they remain for all other purposes independent legal persons with their own organs.

The crucial effect of integration is the removal of the limited liability of the principal enterprise for the obligations of the integrated enterprises. In essence, the integrated group consists of a parent and wholly-owned subsidiaries which agree to subject themselves formally to the uniform management of the parent which, in exchange, becomes responsible for all their obligations. Unlimited liability is the price that the parent has to pay for its unlimited power to direct the operations of the subsidiaries. The parent assumes this liability merely upon integration, without any further requirement.

However, it is generally agreed that the provisions about integration have no practical importance because groups consisting of integrated companies are very rare³³.

b. Contractual groups (291-310 AktG)

Enterprises between which a control contract exists are considered as joined by uniform management, and therefore, they constitute a group³⁴. A control contract is usually concluded between a controlling enterprise and one or more enterprises which are dependent on it³⁵. The contract must be in writing and must be approved by the shareholders' meetings of all the participating enterprises by the holders of at least three quarters of the share capital represented at the passing of the resolution³⁶.

31. AktG, art. 322 (1).

32. EMMERICH & SONNENSCHNEIN, *Konzernrecht*, 4th ed., 1992, p. 123.

33 K. HOFSTETTER, *Parent Responsibility for Subsidiary Corporations: Evaluating European Trends*, 39 I.C.L.Q. 1990, p. 576 at 580; M. LUTTER, *The Liability of the Parent Company for the Debts of its Subsidiaries under German Law*, J.B.L. 1985, p. 499 at 502.

34. AktG, art. 18 (1).

35. FR. WOOLDRIDGE I, *op. cit.*, p. 59.

36. AktG, sec. 293.

A control contract gives the controlling enterprise the right to give instructions and directions to the board of management of the dependent enterprise. The management of the dependent enterprise is obliged by law to follow these instructions and directions unless it is obvious that they do not serve the interests of the controlling enterprise or the interests of the enterprises connected with it and the dependent enterprise, as a group³⁷.

Thus, "a controlling enterprise is permitted to order a dependent company to sell goods to it at prices below the prevailing market price. It may also demand that a certain line of production shall be discontinued; that certain employees shall be dismissed, and that funds belonging to the dependent company shall be placed at its disposal, or the disposal of another company belonging to the same group"³⁸.

The use of the assets of the dependent enterprise by the controlling enterprise, such as payments, deliveries or services rendered to the controlling enterprise on the basis of an instruction given to the dependent enterprise, are not treated as being a violation of arts 57, 58 or 60 AktG, which are concerned with the maintenance of the company's assets to cover its capital and reserves³⁹.

The broad authority of the controlling enterprise in directing the dependent is balanced by the former's obligation to compensate the latter for every loss which has suffered during the term of the agreement⁴⁰. The creditors of the dependent enterprise have no right of action against the controlling enterprise but they can enforce the compensation claim against it in accordance with the powers given to them by the Civil Procedure Code. In the event of the termination of the agreement, the controlling enterprise must provide security to the creditors of the dependent enterprise for claims arisen prior to the publication of the entry of the termination in the trade register⁴¹.

The German legislature intended that groups consisting of companies linked by control contracts would become the most popular form of corporate affiliation. Thus, significant tax motives were provided for the conclusion of control contracts, especially if they were accompanied by

37. AktG, arts. 308 (1) and (2).

38. FR. WOOLDRIDGE II, *op. cit.*, p. 119.

39. AktG, art. 291(3).

40 AktG, art. 302.

41. AktG, art. 303 (1).

profit transfer contracts⁴², and the pursuit of the interests of the group as a whole was legalized.

However, control contracts are very rarely used. Although it was estimated in 1965 that 70% of all German stock corporations (AG) and 20% of the private limited liability companies (GmbH) were already dependent enterprises⁴³, enterprise contracts including control contracts were concluded in respect of only 130 corporations, between 1970 and 1979⁴⁴. As it is felicitously pointed out "the great majority of parent companies have chosen cohabitation without marriage certificates"⁴⁵.

Nevertheless, the regulation of the creditor's protection in contractual groups serves as an example of the linkage between the exercise of managerial control by the parent company and its liability for the losses of the subsidiary. It is significant that, in an integrated group where the controlling enterprise has essentially unlimited power to direct the dependent, the controlling enterprise has unlimited liability for all the obligations of the dependent enterprise and this liability can be directly enforced by creditors.

In contractual groups, however, where the power of the controlling enterprise to direct the dependent is somehow limited, the liability of the controlling enterprise is, also, limited, i.e. it is confined to any deficit of the dependent enterprise occurring during the contract period, and a creditor has no right of direct action against the controlling enterprise for the purpose of satisfying his claim against the dependent.

c. *De facto* groups (311-318 AktG)

If a controlling and one or more dependent enterprises are joined under the uniform management of the controlling enterprise but no integration or control contract exists between them, a *de facto* group is formed⁴⁶. A dependent enterprise is presumed to form a *de facto* group with its controlling enterprise⁴⁷.

42. H. WIEDEMANN, *op. cit.*, pp. 29-31.

43. K. HOPT, *op. cit.*, p. 81.

44. H. WIEDEMANN, *op. cit.*, pp. 28-29.

45. K. HOPT, *op. cit.*, p. 95.

46. AktG, art. 18 (1).

47. AktG, art. 18 (1), sent. 3.

In the absence of integration or a control contract, the statute, in principle, prohibits the controlling enterprise from subordinating the interests of the dependent. It is provided that, in the absence of a control contract, a controlling enterprise may not use its influence to cause a dependent stock corporation (AG) or an association limited by shares (KGaA) to enter into any transaction detrimental to itself, or to cause it to take or abstain from taking any measure whereby it suffers a disadvantage, unless this detriment or disadvantage is compensated for by equivalent gains or advantages⁴⁸. A dependency report on the relation between the two enterprises must be prepared annually by the managerial board of the dependent enterprise and must be examined by a certified accountant⁴⁹.

Where the controlling enterprise fails to compensate the dependent for any inflicted disadvantages by the end of the fiscal year, the controlling enterprise and the responsible legal representatives become jointly and severally liable to the dependent for any resulting damage⁵⁰. If the members of the management board and the supervisory board of the dependent enterprise fail to fulfil their obligations in respect of the dependency report, this joint and several liability is extended to them, as well⁵¹. The shareholders or the creditors of the dependent enterprise may enforce the claims of the dependent enterprise under arts. 317 and 318 by way of a derivative action⁵².

The controlling enterprise and its legal representatives will not incur liability for damages if an orderly and conscientious manager of an independent enterprise would have entered into the relevant transaction or would have taken or omitted the relevant measure⁵³.

De facto groups are much more common than contractual groups and they actually constitute the predominant form of corporate affiliation in Germany. However, the provisions on the

48. AktG, art. 311 (1).

49. AktG, art. 312 et seq. The 1991 dependency report of Adidas AG (Annual Report 1991, pp. 23-24) contains the following statement:

"In the year under review no legal transactions with third parties took place upon request of or in the interest of the controlling company. Likewise, there were no measures taken or arranged upon request of or in the interest of the controlling company in the 1991 financial year. Finally, we declare that for the legal transactions stated in the report concerning intercompany relations our Company received appropriate compensation for each and every transaction according to the circumstances of which we were aware at the time such transactions took place. There were no measures taken or arranged upon request of or in the interest of related companies."

50. AktG, art. 317 (1), (3).

51. AktG, art. 318 (1), (2).

52. AktG, arts. 317 (4) and 318 (4).

53. AktG, art. 317 (2).

creditors' protection suffer from a number of serious defects. Although it appears that substantial obligations and duties are imposed on controlling enterprises and a considerable degree of protection is provided to creditors of the dependent enterprises, the enforcement of the relevant provisions is extremely difficult in the majority of the cases; they are rightly described as provisions without teeth⁵⁴.

Indeed, successful actions for damages under arts. 317-318 AktG are apparently unknown⁵⁵. This is due to the following reasons:

1. The provisions concerning *de facto* groups are not applicable in groups where the dependent enterprise has the form of a private company (GmbH) or a partnership other than a partnership limited by shares.
2. The claim for compensation becomes void if the management board of the dependent enterprise declares that the controlling enterprise did not occasion the detrimental transaction⁵⁶.
3. The compensation system cannot work in cases where the controlling enterprise takes such complete control of the dependent enterprise's affairs that it is nearly impossible to isolate a single transaction and to calculate the damages resulting therefrom, especially if the plaintiff lacks knowledge of the internal affairs of the group⁵⁷.

Nevertheless, like the other provisions of the *Konzernrecht* on creditor's protection, the relevant provisions on *de facto* groups serve as another example of the linkage between managerial control and liability of the controlling enterprise. Unlike integrated and contractual groups where the controlling enterprise has the right to subordinate the interests of the dependent enterprise, in *de facto* groups such right is not recognized. Accordingly, no liability is, in principle, imposed on the controlling enterprise. Where, however, the controlling enterprise violates the prohibition of detrimental influence on the dependent enterprise, it assumes liability for any damage resulting therefrom. Hence, liability is imposed on the controlling enterprise not merely upon proof of a debt or annual deficit of the dependent enterprise as is the case in integrated and contractual groups, respectively; instead, a detriment to the dependent enterprise which arose as a result of the influence of the controlling enterprise should be established.

54. K. HOFSTETTER, op. cit., p. 581.

55. M. SCHIESSL, op. cit., p. 501, fn. 114; H. WIEDEMANN, op. cit., p. 37.

56. H. WIEDEMANN, op. cit., p. 37.

57. Wooldridge enumerates a number of further difficulties involved in calculating damages as well as in calculating whether such damages have been compensated for: the difficulties of estimating the consequences of long-term supply contracts between parent and subsidiary companies, the difficulties arising in relation to transactions when the goods bought and sold have no market price and the difficulties involved when the group operates at a number of different levels and especially, when it is a multinational enterprise. FR. WOOLDRIDGE II, op. cit., p. 120.

iii) The approach of jurisprudence: Qualified *de facto* groups

The defects of the provisions on *de facto* groups and especially the requirement to isolate a single transaction and to assess the damages suffered by the dependent enterprise became the subject of severe criticism by several scholars⁵⁸ and led to the enunciation of the concept of the qualified *de facto* group.

The definition of qualified or closely integrated *de facto* groups is still relatively open. Lutter defines them as groups in which the controlling enterprise constantly interferes with the management of the dependent enterprise, and therefore makes the dependent enterprise totally serve its own purposes⁵⁹; Emmerich and Sonnenschein define them as groups in which the controlling enterprise has an extensive and systematic involvement in the dependent enterprise's affairs, such that the interests of the latter are lastingly prejudiced by reason of this influence⁶⁰. Hofstetter defines qualified *de facto* group as a corporate group structure in which the parent, as a mere shareholder, exerts a long standing and pervasive control pattern over the daily affairs of the subsidiary⁶¹.

It is contended that a qualified *de facto* group exists where the dependent enterprise is treated as if it is a branch of the controlling enterprise or where the latter becomes responsible for the dependent's management on a long-term basis; or where a certain number of persons sit on the boards of both enterprises; or, especially, where certain of the tasks of the executive board of the dependent enterprise are transferred to the controlling, or another enterprise in the same group⁶².

In a qualified *de facto* group, it is no longer possible to isolate a particular transaction entered into by the dependent enterprise at the instance of the controlling enterprise and to calculate the damages resulting therefrom. Thus, an increasing number of scholars propose that in such groups, instead of applying the compensation provisions for ordinary *de facto* groups, the

58. UL. IMMENGA, *The Law of Groups in the Federal Republic of Germany*, in E. WYMEERSCH (ed.), *Groups of Companies in the EEC, A Survey Report to the European Commission on the law Relating to Corporate Groups in various Member States*, 1993, p. 85, at 108-109; M. SCHIESSL, *op. cit.*, p. 501, fn. 113.

59. M. LUTTER, *op. cit.*, p. 502.

60. EMMERICH & SONNENSCHN, *Konzernrecht*, 3rd ed., 1989, quoted in FR. WOOLDRIDGE, *Closely Integrated De Facto Groups under German Law*, E.B.L.R. 1992, (hereinafter cited as FR. WOOLDRIDGE III), p. 67, at 67-68.

61. K. HOFSTETTER, *op. cit.*, p. 583.

62. FR. WOOLDRIDGE III, *op. cit.*, p. 68.

compensation provisions for contractual groups should apply by way of analogy; the controlling enterprise should assume the losses of the dependent enterprise because the controlling enterprise exercises its management rights as if a control contract exists⁶³. Some others, however, contend that qualified *de facto* groups with a public company (AG) as a dependent enterprise should be treated as prohibited by law in the absence of a control contract approved by the shareholders' meeting of the dependent enterprise concerned⁶⁴. Notwithstanding that the latter view does not find any support in the actual wording of arts. 311- 318, there may be little practical difference between this view and the view that qualified *de facto* groups are not prohibited by law⁶⁵.

The courts, in enunciating and clarifying the concept, have participated in the debate over the scope and the legality of qualified *de facto* groups. As a result of a number of decisions of the Supreme Court, qualified *de facto* groups with a private company or a partnership as a dependent enterprise are now considered lawful and can be regulated by rules similar to those applicable to contractual and integrated groups, although these rules are only applicable where the dependent enterprise is a public company⁶⁶.

The decision which paved the judicial way towards the recognition of such groups was the Gervais⁶⁷ case in 1979. In that case, a subsidiary GmbH & Co KG (a type of limited partnership in which a private company is the unlimited partner and its shareholders are the limited partners) had its business integrated into that of the defendant public company. The court found that the dependent company was only theoretically an independent entity and, in reality, it was treated as a mere branch of the defendants⁶⁸. Accordingly, the Federal Supreme Court required the defendant company to assume the losses of the limited partnership during the period of control as if the two enterprises had formed a contractual group under the provisions of *Konzernrecht*:

"In the end, the controlling enterprise had the uncontrollable opportunity to determine the subsidiary's management policy, especially with respect to

63. M. LUTTER, *The Law of Groups of Companies in Europe: A Challenge for Jurisprudence*, 1983, p. 27; FR. WOOLDRIDGE III, *op. cit.*, p. 68; see also M. SCHIESSL, *op. cit.*, p. 501, fn. 116.

64. M. SCHIESSL, *op. cit.*, p. 501; see also FR. WOOLDRIDGE III, *op. cit.*, p. 68.

65. FR. WOOLDRIDGE III, *ibid.*

66. The discussion on the cases on qualified *de facto* groups which follows is mainly based on FR. WOOLDRIDGE III, *op. cit.*, and on FR. WOOLDRIDGE, *The German Supreme Court Further Develops the Legal Rules Governing Qualified De Facto Groups*, submitted for publication in E.B.L.R. 1993 (hereinafter referred to as FR. WOOLDRIDGE IV).

67. BGH, (1980) NJW 231.

68. *Ibid.*, at 231.

production, distribution and investment, and to adjust and to subordinate it to its own concerns. This situation inevitably calls for the obligation to assume the losses of the controlled company during the period of control."⁶⁹

In Autokran⁷⁰, the defendant had incorporated seven private companies in which he was the sole shareholder and manager. Another company in the same group was responsible for the accounting and financing of the whole group. As a result of factoring contracts between this company and the other seven, the defendant was able to receive all their profits with the effect that the companies were unable to achieve financial independence. The plaintiff, who had delivered equipment to the seven companies, failed to obtain payment through execution against their assets and brought suit against the controlling enterprise⁷¹.

The Federal Supreme Court, upholding the approach taken in Gervais, accepted the obligation of a controlling enterprise to assume the losses of the dependent in a qualified *de facto* group and extended this obligation in cases where the dependent enterprise is a private company. But because it was considered that this obligation is aimed primarily at the protection of minority shareholders, the court doubted whether such an obligation exists towards a wholly-owned subsidiary. Instead, the court held that the controlling enterprise should be directly liable to the creditors of the dependent companies for claims exceeding their assets as if the two companies were formally integrated⁷².

It was held that where a parent company is permanently and extensively involved in the management of a now bankrupt subsidiary, a rebuttable presumption exists that the parent did not show sufficient consideration for the subsidiary's best interests. This presumption could be rebutted if it could be shown that the careful and conscientious managers of an independent company, acting in accordance with their duties, would not have run the business in a different way⁷³.

69. Ibid., at 232, as translated by M. SCHIESSL, op. cit., p. 503.

70. 95 BGHZ 330 (1985).

71. The sole shareholder of the seven companies was regarded as an enterprise because he held a potentially controlling participation in several companies and, in addition, he was active as an entrepreneur in at least one enterprise. It is recognized in German law that a natural person may constitute an enterprise if he pursues a number of entrepreneurial interests in a number of different companies. See BGHZ 69, 334, 337, BGHZ 95, 330, 337, BGHZ 115, 187, 189; see also, H. WIEDEMANN, op. cit., pp. 31-32.

72. Op. cit., at 346, 347.

73. Ibid., at 344; see M. SCHIESSL, op. cit., at 505-506.

In Tiefbau⁷⁴, the Supreme Court took a more restrictive approach to the rebuttal of the presumption of detriment. In that case, it was found that a bank was responsible for the management of its dependent non wholly-owned private company in a lasting and comprehensive manner. The bank induced the private company to enter into a number of transactions which were disadvantageous to it, and the company became bankrupt. Because the bank was unable to show that the losses suffered by the dependent company arose from circumstances unconnected with its management, the bank was required to compensate the trustee for the losses of the bankrupt dependent company. The Supreme Court held that art. 302 was applicable by way of analogy.

The standard of the conduct of the "careful and conscientious managers of an independent company" was rejected by the Court on the ground that in qualified *de facto* groups where the dependent enterprise is a private company having more than one member, art. 302 serves as a substitute for the normal rules governing the maintenance of capital. Thus, according to the Court, the duty to compensate for the losses of the dependent company could not depend on whether the "careful and conscientious managers of an independent company" would have acted in a different way⁷⁵.

In Video⁷⁶, an attempt was made to reconcile the two different grounds for the rebuttal of the presumption of detriment. In that case, the plaintiff company was the supplier of video films to an one-man private company which was heavily indebted to the plaintiff. The private company was struck off the register because it had no assets in 1988. The plaintiff brought an action against the sole shareholder and manager of the private company requiring him to pay the debts due together with interests and the costs of an action against the one-man company the judgement in which the plaintiff was unable to enforce. The plaintiff argued that it could attach the one-man company's claims against its sole shareholder relying upon the application of arts. 302 and 303 by way of analogy.

The Supreme Court upheld the plaintiff's claim. Because the defendant was a majority shareholder in four other private companies in the video industry and also carried on a video business of his own, the Court treated him as an enterprise⁷⁷. The Court regarded that the defendant, by virtue of his position as the sole shareholder and manager of the company, had

74. 107 BGHZ 7 (1989).

75. FR. WOOLDRIDGE III, *op. cit.*, p. 69.

76. 115 BGHZ 187 (1991).

77. See *supra*, fn. 71.

comprehensive and lasting control over the company. In such circumstances, because of the procedural difficulties encountered by the plaintiff and especially because of its lack of knowledge of the internal affairs of the group, there was a rebuttable presumption of liability. The Court considered that there was no fundamental difference between the decisions in Autokran and Tiefbau as to the grounds upon which this presumption could be rebutted because the phraseology in Autokran referred rather to the assumption of risk by the management of the group than to any faults in their management⁷⁸. The Court also held that a one-man company is entitled to invoke the protective provisions of arts. 302 and 303 and that in qualified *de facto* groups, like in contractual groups, art. 302 performs the function of substituting for the provisions governing the maintenance of capital.

The decision in Video has been severely criticised by many textwriters⁷⁹. The presumption employed by the Supreme Court and especially its application to one-man private companies has been the subject of academic debate. It has been argued that there is no empirical evidence supporting the use of the presumption and there are cases where it may be very difficult to rebut it. It has also been argued that the result of the decision in Video contravenes the principle of limited liability which is normally applicable to one-man private companies⁸⁰ and is also contrary to certain of the provisions of the Twelfth EC Directive which applies limited liability to such companies, although paras 5 and 6 of the Preamble to the Directive and art. 2(2) provide for certain exceptions⁸¹.

A complaint (*Verfassungsbeschwerde*) has been made to the Constitutional Court about this decision⁸². According to the complaint, the decision is unconstitutional because it constitutes a violation of art. 20 (3) of the German Constitution (*Grundgesetz*) according to which the executive and judiciary authorities shall be bound by the law and justice. Essentially it is argued that the decision excludes the application of limited liability in circumstances where such application is imposed by law although the decisions of the courts should be bound by the existing law.

78. FR. WOOLDRIDGE III, op. cit., p. 70.

79. See in particular, HOMMELHOFF/STIMPEL/ULMER (ed.), *Heidelberger Konzernrechtstage: der qualifizierte faktische GmbH-Konzernen*, 1992; KLEINDIEK, *Haftung, Freie Beweiswürdigung und Beweisleichterung in qualifizierten faktische GmbH-Konzernen*, *GmbH Rundschau*, 1992, 574, 580; FLUME, ZIP 1992, 817. All are cited in FR. WOOLDRIDGE IV, op. cit.

80. GmbHG, art. 13 (2); see FR. WOOLDRIDGE III, op. cit., p. 70.

81. See *supra*, ch. VII, B, i, c.

82. ZIP 1991, 1354.

According to the objection filed by the Federal Government against the complaint⁸³, there is nothing unconstitutional in the Video judgement; the judgement is compatible with the basic law and the Supreme Court has not exceeded the bounds within which judges may develop the law. If, according to the opinion of the Federal Government, the legislature intended to exclude the application of the group liability rules of the *Aktiengesetz* in groups with private companies as dependent enterprises, it would also exclude the application of arts. 15-18 in such groups. Insofar as arts. 15-18 of the *Aktiengesetz* are held applicable in private companies, the Supreme Court was correct in filling the gap which existed in the law of groups, as far as private companies (GmbH) as dependent enterprises were concerned⁸⁴.

Although the Constitutional Complaint has not yet been decided, the approach to the qualified *de facto* group taken in *Video* was reinterpreted and modified in *TBB*⁸⁵. In that case, the defendant was carrying on an unincorporated business and was also the shareholder and manager of two private companies and responsible for the management of a GmbH & Co KG⁸⁶ and a limited partnership (KG). In addition, he was sole manager of TBB, a private limited company in which his wife was the sole shareholder, allegedly as his nominee. All the undertakings were carrying on business in the building industry and they were all eventually struck off the register. The plaintiff sought to enforce one of the claims he had against TBB against the defendant on the basis of the existence of a qualified *de facto* group relationship between the defendant and TBB.

In the lower court⁸⁷, it was evidenced on the basis of cross-guarantee and set-off arrangements with a bank that TBB had no real economic independence but it had to be regarded as being in the nature of a branch of the defendant's business. Thus, a qualified *de facto* group was formed between the defendant and TBB, to which the presumption that the controlling enterprise paid insufficient attention to the interests of the subsidiary was applicable. Accordingly, the defendant was held liable under the analogous provisions of arts. 302 and 303.

The Supreme Court emphasized that the rationale for the rules of liability in *de facto* groups is the possibility of a conflict of interests and that these rules are applicable where the controlling enterprise is a natural person. However, the Supreme Court took care to limit the ambit of its

83. ZIP 1992, 1664.

84. Note, however, the opinion of H. Altmeyden to the contrary effect (ZIP 1992, 1668).

85. ZIP 1993, 589; see FR. WOOLDRIDGE IV, op. cit.

86. See *supra*, in the comments on *Gervais*.

87. OLG Oldenburg, ZIP 1992, 1632, note by Kowalski.

earlier judgements in Autokran, Tiefbau and Video⁸⁸, and it proceeded upon the formulation of new principles governing qualified *de facto* groups. Whereas the previous decisions based the imposition of liability on the controlling enterprise on the presumption of detriment to the dependent enterprise where there was comprehensive and lasting control over its affairs, the Supreme Court in TBB took a totally different view. The Supreme Court held that the basis of liability in the previous cases was not lasting and comprehensive control over the dependent company but a prejudice caused to its interests. Such prejudice could not, in the opinion of the Court, be said to occur on a basis of presumption resulting from such control. Its existence had to be based on additional factors.

Thus, instead of relying on the presumption, the plaintiff had to particularise and give evidence of facts leading to the conclusion that the management of the group had taken place in the groups' own interests, such that the interests of the dependent private company had been prejudiced in a manner not susceptible to individual compensatory measures. However, because of the difficulties in particularising detrimental transactions and measures, the Supreme Court considered that a lesser burden of particularising and giving evidence of facts should be imposed on a creditor of a subsidiary who lacked insight into the affairs of the group. It was the defendant who, according to the Court's opinion, should bear the burden of giving fuller evidence for facts which were within his knowledge but outside the knowledge of the plaintiff. If the defendant failed to do so, the plaintiff might well win the case even if his pleadings did not contain all the relevant particulars.

The Supreme Court gave the parties the opportunity to amplify their pleadings so as to take account of certain aspects of its judgement. Thus, the lower court will have to determine again whether the defendant is directly liable to the creditor company by virtue of art. 302. Whatever the result of the rehearing of the case may be, it is beyond doubt that the decision of the Supreme Court in TBB is expected to have a dramatic impact on the qualified *de facto* group concept. The cornerstone of this concept, i.e. the presumption of detrimental interference with the subsidiary's affairs has essentially been abandoned. In its place, the Supreme Court suggested a lightened burden of proof for the defendant in order to overcome the difficulties in particularising detrimental transactions and measures.

Although the presumption used in the previous cases was not free from difficulties, it proved a workable principle for dealing with the liability of the controlling enterprise. Perhaps, what needed further elaboration and clarification was the ground upon which this presumption could

88. See also Gergen, OLG Saarbrücken, ZIP 1992, 1623, note by Drygala.

be rebutted. The new principle of liability suggested in TBB, however, is unlikely to operate the same effectively in practice. It suffers from two main disadvantages:

1. It cannot in practice be determined what is the sort and the degree of the procedural relief proposed for creditors. If what the Supreme Court actually suggested was a limited reversal of the burden of proof, this reversal might more safely and effectively take place by the use of a presumption as the one used in the previous cases but with a more workable ground for rebuttal.
2. If the reduction of the burden of proof suggested in TBB is available only to creditors who lack insight into the affairs of the group, as seems to be the intention of the Supreme Court, different principles of liability will apply for different plaintiffs. This may promote the flexibility of the courts but, on the other side, it may generate a great deal of uncertainty as to whether a particular plaintiff is entitled to the reduction of his burden of proof.

It seems, therefore, that the previous decisions of the Supreme Court provide a more workable starting point for a solution to the group liability issue. Presumptions are easier to use and safer to rely upon. A reduction but not a complete reversal of the burden of proof may prove difficult in its use and unpredictable in its effects.

In any event, the qualified *de facto* group concept constitutes a significant step towards a realistic approach to the issue of the imposition of liability on the controlling enterprise. In spite of the absence of integration and a control contract, liability may be imposed on a parent company merely upon evidence of a continuous and extensive interference with the subsidiary's management (according to the previous approach) or upon some evidence of prejudice of the subsidiary's interests (according to the approach taken in TBB).

However, some issues remain still unresolved. The qualified *de facto* group still awaits a precise definition. It is unclear whether the jurisprudence considered above is applicable to qualified *de facto* groups with a public company as the dependent enterprise. Wooldridge believes that a similar approach can be taken by the courts in cases where the dependent enterprise is a public company⁸⁹. It is hoped that the final outcome of the TBB case together with the decision on the Constitutional Complaint against Video will provide some answers and develop further the law governing qualified *de facto* groups.

iv) Overall assessment

89. FR. WOOLDRIDGE III, *op. cit.*, p. 70.

The German regulation of groups with its legislative and judicial components is ambitious in its purpose and comprehensive in its scope. It is based on the central assumption of German company law "that in an independent commercial company there exists an internal equilibrium among the shareholders, and that, therefore, ideally both the basic decisions and the management are oriented around the common company interest. The interests of creditors and employees are thereby simultaneously and indirectly protected"⁹⁰.

This internal equilibrium may, however, be distorted when one shareholder or a group of shareholders acquires a majority interest in the company and is in a position to pursue his own interests at the expense of other interests which are relevant for company law. The probability of distortion is greater when the controlling member is active in an enterprise out of the company, i.e. when another enterprise - which can be an individual or a company⁹¹ - obtains a controlling influence. The controlling enterprise, especially when it is engaged in a related line of business, may use its own influence over the dependent company to the latter's detriment, not only by affecting business decisions but by transforming the dependent company into an operational division or a branch within its own organizational framework⁹².

Thus, there is a qualitative difference between a company controlled by a majority shareholder and a company controlled by another enterprise. The typical majority or the sole shareholder is mainly interested in the profitability of his company since he has no other business interests. On the contrary, the interests of a controlling enterprise which carries on business outside the dependent enterprise, are much more likely to conflict with the interests of the dependent. Accordingly, the conduct of a controlling enterprise may be much more dangerous for the interests of its dependent enterprise than the conduct of a majority or sole shareholder for his company's interests.

The German legislature and the courts consider it necessary to intervene in cases where the so-called internal equilibrium is manifestly disturbed, i.e. in cases where the controlling enterprise is suspected of exploiting the dependent enterprise. Accordingly, direct or indirect liability is imposed in every case where a controlling enterprise is allowed to exercise or has actually exercised or it is presumed to have exercised its controlling influence in a detrimental manner for the dependent company. Whether the liability imposed is direct or indirect depends on the form of corporate affiliation adopted:

90. H. WIEDEMANN, *op. cit.*, pp. 21-22; see also M. SCHIESSL, *op. cit.*, pp. 483-484.

91. See *supra*, fn. 71.

92. See fn. 90.

1. In an integrated group, the controlling enterprise is jointly and severally liable for all existing and future creditors' claims against the dependent (AktG art. 322).
2. In a contractual group, the controlling enterprise is obliged to compensate the dependent for all annual losses incurred during the contract period (AktG art. 302).
3. In a *de facto* group, the controlling enterprise is obliged to compensate the dependent enterprise for any disadvantageous interference with the latter's business (AktG art. 317).
4. In a qualified *de facto* group, a rebuttable presumption existed that the controlling enterprise did not show sufficient consideration for the dependent's interests; unless this presumption was rebutted, the controlling enterprise was liable as if the two companies were formally integrated or contractually bound by virtue of a control contract. By virtue of its judgement in TBB, the Supreme Court abandoned the presumption and replaced it by a reduction of the burden of proof placed on the plaintiff.

Taking into account that successful actions for damages under the provisions on *de facto* groups are evidently unknown and that integrated and contractual groups are very rarely formed, it seems that the only effective way of protecting the creditors of a subsidiary is the qualified *de facto* group concept. However, all the forms of liability imposed have their theoretical importance since they indicate distinct possibilities of abrogating the limited liability of the parent on the ground of its managerial control over the subsidiary.

B: THE FRENCH APPROACH

i) Definitions

Unlike its German counterpart, French law has not developed a set of rules specifically applicable to groups of companies. A proposal for a law on group of companies, the so-called *Proposition Gousté*, did not proceed further⁹³. The last version of this proposal was presented to the French Parliament in 1978 and its structure and text was very similar to the German provisions on groups⁹⁴.

The law of 24 July 1966 on *sociétés commerciales* does not give a definition for groups of companies as such, but, instead, gives definition for the subsidiary (*filiale*) and for mere

93. R. HOUIN, *Les Groupes de Sociétés en Droit Français*, in K. HOPT (ed.), *Groups of Companies in European Laws*, op. cit., p. 45 at 56-57.

94. For the full text of this version, see K. HOPT (ed.), *ibid.*, pp. 296 et seq.

participation. Article 354 thereof provides that subsidiary is the company in which another company holds more than half of its capital; article 355 provides that a participation exists in cases where one company holds between 10% and 50% of the capital of another.

These definitions, in sharp contrast with the German ones, give emphasis to the ownership links between two companies and they do not make use of the economic criteria of dependency and uniform management. However, these definitions have limited value since they are relevant only for the application of the provisions concerned (arts. 354-359) and of some others where an express reference is made⁹⁵.

A more flexible approach is adopted in the definitions of control. Article 3 of the law no. 85-705 of 12 July 1985, which added three new provisions (arts. 355-1 to 355-3) to the law of 1966, defines control for the purposes of disclosure to the shareholders and the public and for the purposes of the rules governing cross-participation. A company is treated as controlling another in three different situations:

1. When it directly or indirectly holds a fraction of another company's share capital conferring on it the majority of the votes at the general meetings of the company (*contrôle de droit*).
2. When it possesses the majority of the voting rights in the company by virtue of an agreement concluded with the other shareholders which is not contrary to the company's interests (*contrôle conjoint*).
3. When it has the *de facto* power, by exercising the votes which it disposes of, of determining the decisions at the general meetings of the company (*contrôle de fait*). This provision envisages the situation where, because of the dispersal of shareholdings, a shareholder is in a position to control the company although he does not dispose of the majority of voting rights. *Contrôle de fait* is presumed where a company, directly or indirectly, disposes of more than 40% of the voting rights in another company and no other member, directly or indirectly, holds a larger percentage⁹⁶.

95. G. RIPERT, R. ROBLOT, *Traité Elementaire du Droit Commercial*, 14th ed., t. 1, 1991, para 712, p. 582; R. HOUIN, *op. cit.*, p. 46.

96. According to G. RIPERT, R. ROBLOT, *op. cit.*, para. 712, p. 583, the presumption is rebuttable.

There is also a number of other definitions for the links between two companies, for instance in tax law, in labour law and in the law of accounts which implements the Seventh Directive⁹⁷, which rely either on formal criteria or on economic ones or on a combination of both⁹⁸.

ii) The approach of jurisprudence

Because of the absence of specific regulations applicable to the group of companies as a distinct legal form of carrying on an economic activity, the principles of ordinary company law apply. Thus, a company belonging to a group has full legal personality of its own as though it was an economically independent unit and, in principle, the parent company cannot be held liable for the obligations of its subsidiary⁹⁹.

In one case¹⁰⁰, a creditor attempted to hold the parent company liable for the debts contracted by its sub-subsidiary. The two companies had the same object, the top executive of the subsidiary was a former official of the parent and the assistant general director of the parent was also a manager of the subsidiary. The subsidiary had only a nominal amount of capital and it was obviously unable to carry on its activities without financial support from the parent. On these facts, the plaintiff argued that "the parent carried on its activities under the cover of the subsidiary which had no autonomy at all, in a way that the former should necessarily meet the obligations of the latter"¹⁰¹. The Supreme Court rejected this argument on the ground that each of the two companies in question had legal personality such that the plaintiff could not have confused the activities and the interests of the subsidiary with those of the parent¹⁰².

In another case¹⁰³, a company concluded a contract of exclusivity for the disposal of its products by the plaintiff company. After the conclusion of the contract, the first company became a member of a group dominated by a parent company, the defendant, which was manufacturing the same product. Whereas the subsidiary respected the contract throughout the

97. Law 85-11 of 3 January 1985.

98. G. RIPERT, R. ROBLOT, *op. cit.*, p. 583. The French *Conseil d'Etat* held in a case which has subsequently been followed that, for the purposes of art. 57 of the General Tax Code, a French enterprise is controlled by a foreign enterprise where, *inter alia*, the foreign enterprise exercises in the French enterprise, directly or through intermediaries such functions that it possesses the power to make decisions. See FR. WOOLDRIDGE II, *op. cit.*, p. 108, fn 30.

99. G. RIPERT, R. ROBLOT, *op. cit.*, para. 713(2), p. 587.

100. 4 janv. 1982: *Rev. soc.*, 1983, 95, note Burst.

101. *Ibid.*, at 96.

102. *Ibid.*

103. 24 mai 1982: *Rev. soc.* 1983, 361, note Beguin.

contract period, the parent company continued to sell its products freely to competitors of the plaintiff. The plaintiff claimed damages from the parent company for abusive breach of the contract considering that the products of the whole group were under an exclusivity agreement. The Supreme Court considered that the circumstances of the case were not sufficient to hold the parent company responsible for the breach of a contract concluded by the subsidiary because the subsidiary "constituted a legal person distinct from [the parent] in spite of the fact that they belonged to the same group"¹⁰⁴.

In a third case¹⁰⁵, the Supreme Court reversed a decision of the Court of Appeal according to which a guarantee given by a parent company for the performance of obligations of its wholly-owned subsidiary was treated as a guarantee given for the performance of the parent's own obligations. The Supreme Court held that, because parent and subsidiary constitute distinct legal persons, a guarantee by the parent given not for the performance of its own obligations but for the performance of the obligations of its subsidiary, is not valid unless it is subject to the formalities required for guarantees given for the performance of third parties' obligations.

The above cases are representative of the orthodox position¹⁰⁶. Exceptionally however, the principle of legal independence of the companies belonging to the same group is not given full effect¹⁰⁷. In particular, French law admits the possibility of the parent company being held liable for the debts of its subsidiary in three types of situations: where the subsidiary has been created merely to serve the purposes of the parent company¹⁰⁸, where the conduct of the parent company creates the impression to third parties that they deal with a single enterprise¹⁰⁹ and where the parent company does not comply with its statutory duties as the manager of the subsidiary¹¹⁰.

104. *Ibid.*, at 362.

105. 29 nov. 1982: *Rev. soc.* 1983, 615, note Sibon.

106. See also, 4 nov. 1987: *Rev. soc.* 1988, 393, note Le Cannu; Paris, 15 mai 1990: *Bull. Joly*, 1990, 879.

107. It is actually suppressed, as Guyon characteristically says. Y. GUYON, *Droit des Affaires*, t. 1, 6th ed., 1990, para. 618, p. 613.

108. See below, under 1.

109. See below, under 2.

110. See below, under iii.

a. The subsidiary as a fictitious company

The imposition of liability on the parent company for the debts of its subsidiary is, sometimes, based on the concept of the fictitious company (*société fictive*)¹¹¹. The courts make use of this concept where parent and subsidiary are and appear to operate as separate companies, but, in reality, they form a single unit and the subsidiary has been created or used merely for serving the purposes of the parent. This is the case of a subsidiary formed with the sole intention of protecting the assets of the parent from the reach of its creditors or of a subsidiary serving as a cloak for certain of the purposes of its parent.

In one case¹¹², the Supreme Court upheld the extension of the liquidation of a subsidiary to its parent company. The parent company owned nine tenths of the subsidiary's share capital and the rest was owned by the manager of the parent company, who was the husband of the manager of the subsidiary company. It was held that the subsidiary was not in reality a separate economic entity but that it merely served as a cloak for the parent's activities.

In another case¹¹³, the liquidation of a subsidiary was extended to its parent company which held nine tenths of the subsidiary's share capital. The two companies had the same object, name and address, and used the same headed notepaper. They did not keep separate accounts and had the same bank accounts. In addition, there was a management contract between them according to which the subsidiary had the obligation to provide the parent with all its requirements. The Supreme Court held that the subsidiary was merely the nominee of its parent and that it was used as a cloak for the parent's activities.

In a third case¹¹⁴, the Supreme Court upheld the extension of the liquidation of a parent company with its subsidiaries to another company which was the franchiser of the trademark exploited by the other companies. The franchiser company was treated as a *société fictive* which was a distinct legal person only in appearance but in reality it formed with the other companies of the group a single enterprise. It was found that there were tight interrelationships between the franchiser company and the other companies of the group and that the activities of all the companies concerned were of a complementary character. The franchiser company had never had employees of its own and it had assigned the execution of all its obligations, as

111. See E.J. COHN & C. SIMITIS, "Lifting the Veil" in the Company Laws of the European Continent, 12 Int'l & Co. L. Qu. 1963, 189 at 209-210.

112. 29 oct. 1957: Rev. tr. dr. com. 1958, 189, note Houin.

113. 6th feb. 1962: Rev. tr. dr. com. 1962, 741, note Houin.

114. 8 nov. 1988: Rev. soc. 1990, 71, note Honorat.

franchiser of the trademark, to the franchisee companies, including the whole expenses of publicity for the launching of the trademark.

In a more recent case¹¹⁵, the Supreme Court held that a company was a *société de facade* on the ground that it had the same shareholders, the same managers and the same seat with another company and it was formed with the sole purpose to separate in an advantageous manner different operations connected with the exploitation of a ship.

In general, it appears that, for the purposes of extension of liquidation proceedings, a subsidiary can be considered a fictitious company on the basis of two different sets of criteria. First, a number of legal criteria have to be met: the two companies should have common shareholders, common managers and common seat. These legal criteria have to be reinforced by a number of economic criteria: the subsidiary should act at the behest of the parent company without any real authority of its own and it should serve as a cover for the activities of the parent company¹¹⁶.

b. *Apparence*

The courts make use of the concept of *apparence* where the parent company treats the subsidiary as though it is a branch or an agency despite its separate legal personality. In this case, the conduct of the parent company gives to third parties the impression that the subsidiary is not an autonomous legal entity but a mere department of itself. Third parties are thus entitled to invoke the apparent existence of one economic entity, consisting of the parent and the subsidiary, for the purpose of imposing liability on the former for the debts of the latter¹¹⁷.

In a case decided by the Supreme Court in 1946¹¹⁸, the doctrine of *apparence* was invoked and an Italian parent company was held jointly and severally liable with its French subsidiary towards a trade creditor of the subsidiary. The parent company owned the large majority of the subsidiary's capital and its director became the manager of the subsidiary. Both companies

115. 28 nov. 1989: Rev. soc. 1990, 240.

116. See note to the decision quoted above, pp. 241-242; for references to some other relevant cases see G. RIPERT, R. ROBLOT, *op. cit.*, para. 713 (2), p. 588.

117. FR. WOOLDRIDGE I, *op. cit.*, p. 115. According to J. DOBSON, "Lifting the Veil" in four Countries: The Law of Argentina, England, France and the United States, 35 I.C.L.Q. 1986, p. 839 at 847, fn. 24), the doctrine of *apparence* "provides a common grounding for different legal remedies where innocent parties have been moved to enter a transaction by a (justifiable) belief in the ostensible legal standing of the other party. Situations as diverse as transactions made by ostensible agents, court-proclaimed heirs, ostensible creditors (who collect) and ostensible owners (who sell) are put on a common theoretical base".

118. 7 jan. 1946, S.1947.1.32, cited in FR. WOOLDRIDGE, Groups of Companies in England, France and Germany, *op. cit.*, p. 116.

had the same objects and the Italian parent called its subsidiary "our house in France" in its correspondence with the trade creditor.

In another case¹¹⁹, a creditor of a subsidiary company attempted to attach contractual responsibility not only against the subsidiary company with which he contracted but also against its parent company and a third company charged with the management of the subsidiary. The Court of Appeal considered that "each of the companies appeared to be mere legal vehicles through which the promoter became able to individualize the enterprise operation and to withdraw discounted profits"¹²⁰. The Supreme Court upheld the decision of the Court of Appeal pointing out that the united appearance of the three companies in the eyes of third parties justified the contractual responsibility of the parent company and the managing company towards the creditor of the subsidiary.

In a more recent case¹²¹, a creditor contracted with what appeared to be a single enterprise with a single name. In reality, however, the enterprise consisted of two companies with slightly different names. They had the same address, a common director, the same object and the same unusual form of *société en commandite* (limited partnership). The unpaid creditor proceeded against one of them but liability was denied on the ground that the other company was the debtor. The Supreme Court, upholding the judgement of the lower court, obliged the defendant company to pay the debt on the ground that third parties who contracted with one of them could not discern which company of the two was actually the party to the transaction in question.

Hence, liability is imposed on a parent company for the debts of its subsidiary on the ground of *apparence* where it is considered that the creditors of the subsidiary are justified in thinking that they are dealing with a single entity responsible as a whole for its obligations. This will be the case of a parent company conducting the operations of its subsidiary in a way that the subsidiary appears to be its branch, and the two companies use the same premises and equipment or have similar names¹²².

119. 13 dec. 1967: Rev. soc. 1969, 152; see also D. SCHMIDT, *La Responsabilité Civile dans les Relations de Groupe de Sociétés*, Rev. soc. 1981, p. 725 at 732-733.

120. Ibid.

121. 15 nov. 1977: Bull. cass. IV, n. 265, p. 225; see also D. SCHMIDT, *ibid.*, p. 732.

122. For references to more cases, see G. RIPERT, R. ROBLOT, *op. cit.*, para. 713 (2), p. 588; FR. WOOLDRIDGE I, *op. cit.*, pp. 115-117.

iii) The statutory provisions

It is suggested that "of all the European countries, French law sets forth in the greatest detail the procedure for the extension of the subsidiary's bankruptcy to include the parent"¹²³.

Articles 180 and 182 of law no. 85-98 of 25 January 1985 on the reorganization and judicial liquidation of enterprises (*redressement judiciaire*)¹²⁴ are applicable to groups of companies¹²⁵.

Article 180 provides that, in the event of a fault in management, those who are responsible in law or in fact for the management or supervision of the company, whether remunerated or not, may be ordered by the competent court to pay the whole or any part of its debts when the company is undergoing reorganization or judicial liquidation (*action en comblement du passif*). Thus, a parent which acted as a *de jure* or *de facto* director of a bankrupt subsidiary may be called upon to pay the subsidiary's debts.

This provision replaced art. 99 of the Bankruptcy Law no. 67 of 13 July 1967. Under that provision, a parent company which, in fact or in law, was responsible for the management of its insolvent subsidiary, could be held liable for all or part of the unpaid debts of the subsidiary if it participated in the direction of the subsidiary's affairs but failed to satisfy the requisite duty of care¹²⁶. The parent company was rebuttably presumed to be at fault in directing the subsidiary and the insufficiency of the subsidiary's assets was irrebuttably presumed to be caused by the fault of the parent. The parent could escape liability only if it could show that it exercised all the necessary care and skill in the management and supervision of the subsidiary's affairs having regard to the surrounding circumstances¹²⁷.

On the contrary, under the current provision, the plaintiff has to establish that the parent company, acting as a *de jure* or a *de facto* director of the subsidiary, has committed a fault in the subsidiary's management which was the proximate cause of the insufficiency of the

123. PH.I. BLUMBERG, *Law of Corporate Groups: Bankruptcy Problems in the Law of Parent and Subsidiary Corporations*, 1985, p. 627.

124. Y. GYUON, *op. cit.*, t. 2, 2nd ed., 1989, paras 1371-1394 and 1399-1406. See also, FR. WOOLDRIDGE II, *op. cit.*, pp. 116-117; K. HOFSTETTER, *op. cit.*, pp. 584-585.

125. Y. GYUON, *ibid.*, paras. 1389, 1402.

126. Aix-en-Provence, 26 mai 1981: R.D.S. 1983, 60.

127. Y. GYUON, *ibid.*, para. 1373; 11 fev. 1980: Rev. soc., 1980, 811, note J.H. See also FR. WOOLDRIDGE I, *op. cit.*, pp. 123-125.

subsidiary's assets¹²⁸. In addition, creditors of the subsidiary can enforce the liability of the parent only derivatively since they do not have a direct claim¹²⁹. It appears, therefore, that the provision can hardly be enforced¹³⁰.

Article 182 extends *redressement* proceedings to the parent company, where the parent company, as a director or shadow director of its subsidiary,

- (1) disposed of the assets of the subsidiary as if they were its own; or
- (2) used the subsidiary as a mask to achieve its own interests; or
- (3) used the assets and credit of the subsidiary in a way that impaired the latter's interests; or
- (4) pursued in its own interests a loss-making activity which could only lead to the subsidiary's insolvency; or
- (5) destroyed documents or failed to keep proper accountability of the subsidiary's affairs; or
- (6) misappropriated the subsidiary's assets or fraudulently overstated its liabilities¹³¹.

Article 182 suffers from the same disadvantages as article 180. It has to be proved that the parent, as a director or a shadow director of the subsidiary, misconducted the subsidiary's affairs in one of the above ways¹³². Moreover, a creditor of the subsidiary cannot enforce the provision¹³³. It is, therefore, doubtful whether the provision provides a realistic chance of holding the parent liable for the debts of its subsidiary.

iv) Overall assessment

Although in French law there is no set of rules specifically applicable to groups of companies, there are two provisions (arts. 180 and 182 of the law of 25 January 1985), which, in appropriate circumstances, may impose liability on a parent company for the debts of its

128. Y. GYUON, *ibid.*, paras. 1374-1377.

129. *Ibid.*, para. 1379.

130. K. HOFSTETTER, *op. cit.*, pp. 585-586. It is significant that even the former version of the provision which was subject to much looser requirements was rarely invoked by a subsidiary's creditors; see D. SCHMIDT, *op. cit.*, p. 729.

131. This provision resembles art. 101 of the law of 1967 which is no longer in force. According to that article, liability could be imposed on the parent company for the debts of its insolvent subsidiary, where the parent company as a *de jure* or *de facto* director committed any of the following acts in its own interests:

- (1) Utilized the subsidiary as a facade for the conduct of its own commercial activity;
- (2) Disposed of the assets of the subsidiary as if they were its own;
- (3) Wrongfully conducted the business of the subsidiary at a loss and continued to incur liabilities which could not be paid.

132. Y. GYUON, *op. cit.*, para. 1402.

133. *Ibid.*, para. 1403.

subsidiary on the basis of interference with the subsidiary's management. However, because of their strict requirements, both provisions have little practical importance.

The courts, when dealing with the liability of the parent for the debts of its subsidiary, have often resorted to the general concepts of *société fictive* and *apparence*¹³⁴. Both concepts may be invoked in cases where the subsidiary is closely controlled by its parent. *Apparence* can be invoked if the close control of the parent renders the subsidiary a mere department of itself such that third parties form the impression that only one economic unit is in existence and operates. The concept of *société fictive* can be invoked if the close control of the parent, although it does not create the appearance of one economic unit, results in that the subsidiary merely serves the parent's own interests.

Unlike the statutory provisions which require evidence of misconduct by the parent, the concepts of *société fictive* and *apparence* link control and liability of the parent on the basis of more neutral behaviour. For liability to be imposed on the parent company, it suffices that the plaintiff establishes the apparent operation of parent and subsidiary as one unit or the fictitious operation of the subsidiary.

Thus, like the German qualified *de facto* group concept before *TBB*¹³⁵, these concepts may be invoked by a creditor who does not need to establish misconduct by the parent. The difference between the German and the French notions lies in that the German concept required permanent and extensive involvement in the management of the subsidiary whereas the French concepts require the fictitious operation of the subsidiary or the apparent operation of one unit. However, insofar as all three concepts proceed upon evidence indicating a substantial degree of managerial control by the parent, the different terms used may be considered as mere differences of expression and not of substance.

C: THE EUROPEAN COMMUNITY EXPERIENCE

The EEC Treaty does not provide a definition for groups of companies. However, in some early decisions of the European Court of Justice an attempt was made to define the group. In

134. It is suggested that liability may be imposed on a parent company by the use of the concept of *confusion des patrimoines*, i.e. the absolute commingling of the assets and affairs of parent and subsidiary. However, there is no clear authority on what conditions the concept may be invoked, and the French scholars consider that this concept is "in a state of flux". F. GISSEROT, *Le confusion des patrimoines: est-elle une source autonome d'extension de faillite*, 32 Rev. trim. dr. comm. 1972, p. 49 at 83. See also PH.I. BLUMBERG, op. cit., pp. 630-632; J. DOBSON, op. cit., p. 860.

135. See *supra*, under A, iii.

a judgement of 1959¹³⁶, the Court stated that, in the absence of specific Treaty provisions, two separate companies could not be deemed to constitute a single enterprise for the purposes of the application of Community measures, "more particularly when they each have distinct legal personality in the eyes of their national law"¹³⁷.

On the contrary, in two tax-law judgements of 1962¹³⁸, the Court held that two or more enterprises can constitute a group if they are managed by a parent company and have a closely integrated production cycle in which the output of the group as a whole, rather than that of the individual subsidiary, is taken into account.

When applying the anti-trust Treaty provisions, the Court adopted a similar notion of the group and elaborated the concept of the unity of the group where the subsidiary was unable to operate autonomously but it carried out the instructions given by its parent company. In cases such as I.C.I. and Others v. Commission¹³⁹, Europemballage Corporation and Continental Can Company Inc. v. Commission¹⁴⁰ and Commercial Solvents Corp'n. v. Commission¹⁴¹, the anticompetitive conduct of the subsidiary was imputed to its parent company outside the E.C. territory on the ground of the unity of the group formed. This unity was ascertained on the basis of factual elements such as the fact that the same persons were members of the managerial boards of the two companies, that the subsidiary was financially dependent on its parent or that the two companies had identical interests in carrying out the transaction in question¹⁴².

In addition to the above cases, there is a number of Community measures and proposals dealing with groups of companies. In these measures and proposals one can find provisions on the liability of the parent company for the debts of its subsidiary. The former Draft Convention on Bankruptcy, the former draft of the European Company Statute as well as the draft proposal for a Ninth Directive on groups of companies are all drafts which have eventually been replaced

136. Joined cases 42 and 49/59, Société nouvelle des Usines de Pontlieu-Aciéries du Temple v. High Authority, (1961) E.C.R. 53.

137. *Ibid.*, at 80.

138. Joined cases 17 and 20/61, Klökner-Werke AG and Hoesch AG v. High Authority (1962) E.C.R. 325; 19/61 S.A. Mannesmann v. High Authority (1962) E.C.R. 357.

139. See *supra*, ch. V, C and D.

140. See *supra*, ch. V, D.

141. See *supra*, ch. V, C and D.

142. See also United Brands Company v. Commission, (1978) E.C.R. 131; Hydrotherm Gerätebau v. Compact (1984) E.C.R. 2999 at 3016 and A. ADINOLFI, *The Legal Notion of the Group Enterprise: The EC Approach*, in D. SUGARMAN & G. TEUBNER (eds.), *Regulating Corporate Groups in Europe*, Nomos Verlagsgesellschaft, Baden-Baden, 1990, p. 495, at 498-501.

or abandoned, but they retain their significance insofar as they can serve as indicators for any future attempt to regulate the liability of the parent company.

i) The Draft Bankruptcy Convention

In the preliminary draft of the proposed Convention on Bankruptcy, Winding-up, Arrangements, Compositions and similar Proceedings (1970)¹⁴³, the Committee of Experts included a provision which was quite similar to art. 101 of the French Bankruptcy Act of 1967¹⁴⁴. Its title was "Extension of the bankruptcy of companies or firms to the persons directing or managing them" and it provided the following:

- "Any person who has *de jure* or *de facto*, and whether openly or secretly, been directing or managing a company or firm which has been declared bankrupt, and who has
- (a) Carried on a personal activity, while using that company or firm as a cloak for misdealings, or
 - (b) Wrongfully dealt with the property of that company or firm as if it were his own, or
 - (c) Wrongfully carried on an insolvent business in his own personal interest,
- may be declared bankrupt, if the dealings referred to at (a), (b) and (c) above led to or contributed to the suspension of payments of the company or firm."

According to this provision, the bankruptcy of a subsidiary could be extended to its parent in circumstances where the parent had mismanaged the subsidiary. This provision proved to be the most controversial of the entire draft and, at its meeting in 1977, the Committee of Experts deleted it¹⁴⁵. The subsequent draft of the Convention, which was eventually abandoned¹⁴⁶, as well as the current 1991 draft which has not yet been published, contain no provisions dealing with this problem but refer such matters to the law of the member state where the bankruptcy was opened.

143. C.E.E. Doc. 3.327/1/XIV/70-E, English Dept. of Trade, Draft Bankruptcy Convention of the European Economic Communities (H.M.S.O. 1974).

144. See *supra*, B, iii.

145. PH.I. BLUMBERG, *op. cit.*, pp. 655-656; C. CONNERTON, *Directors' Liability and the EEC Draft Convention on Bankruptcy*, J.B.L. 1977, p. 8 at 12-14; M. HUNTER, *The Draft EEC Bankruptcy Convention - A Further Examination*, 25 I.C.L.Q. 1976, p. 310 at 319.

146. 2 C.M.R. (CCH) 6111, 6123 (1981).

ii) The European Company Statute

The former draft for a European Company Statute of 1970/1975 ("*Societas Europea*" Statute)¹⁴⁷, contained provisions on groups, applicable where a parent or one of the subsidiaries were incorporated under the Statute¹⁴⁸. If the subsidiary company was formed as a European Company, the Statute's rules for groups applied only to it and to its relations with the parent. If the parent was a European Company, the provisions of the Statute applied to all the companies in the group, both to those incorporated under their national laws and to those formed as European Companies under the rules of the Statute.

According to art. 6 (1), a dependent company was defined as one over which another company was able to exercise, directly or indirectly, a controlling influence. A controlling influence was presumed to be exercisable over a company if another company had a majority shareholding in the former's capital (art. 6 (3)). In this case, the presumption could be rebutted, if, for instance, the parent company could establish evidence that it restricted itself to a mere passive shareholder role¹⁴⁹.

According to art. 6 (2), a company was conclusively presumed to be dependent on another when that other had the power, directly or indirectly in relation to the first:

- (a) to control more than half of the votes at its general meeting; or
- (b) to appoint more than half of the members of its board of management or supervisory board.

According to art. 223, "a controlling company and one or more companies dependent on it shall constitute a group within the meaning of this statute if all of them are under the unified management of the controlling company and if one of them is an SE". The Statute did not provide a definition for unified management, but provided that if a company is dependent on the controlling company it is rebuttably presumed that the two companies form a group (art. 223 (2)).

In circumstances of doubts or disputes arising as to whether or not a group existed within the meaning of art. 223, application for determination could be made to the European Court of

147. For the history of the Statute, see K. GLEICHMANN, *The Law of Corporate Groups in the European Community*, in D. SUGARMAN & G. TEUBNER (eds.), *op. cit.*, p. 435 at 443-444; L.C.B. GOWER, *Gower's Principles of Company Law*, 5th ed., 1992, p. 67.

148. Art. 224.

149. See J. MICALLEF, *The European Company: A Comparative Study with English and Maltese Company Law*, 1975, p. 609; K. HOFSTETTER, *op. cit.*, p. 588.

Justice, under art. 225. Among those entitled to apply were "creditors, if the allegedly controlling company did not pay its alleged subsidiary company's debts" under the provisions of article 239.

Article 239 of the former draft provided:

1. The controlling company of the group shall be liable for the debts and liabilities of its dependent subsidiary companies.
2. Proceedings may be brought against the controlling company only after the creditor has first made a written demand for payment on the dependent subsidiary company and failed to obtain satisfaction.

Article 240 authorised a controlling company to give instructions to the board of the dependent company but required it to exercise the standard of care required of a conscientious manager and to promote the interests of the group and its personnel (art. 240a). Article 240 b imposed on the directors of the controlling company a liability for damage to the dependent group company in relation to their duties under art. 240a.

Although these provisions are not included in the more recent draft¹⁵⁰, their theoretical importance cannot be ignored. The imposition of liability on the parent company was made subject to very loose requirements. A creditor of the subsidiary was not required to prove any sort of fraudulent or reckless misconduct of the subsidiary's affairs by the parent. A group was presumed to be formed between the controlling and the dependent company. The dependency relationship was presumed to exist in circumstances such as the parent's majority shareholding in the subsidiary or the right of the former to appoint more than half of the members of the latter's management board. Essentially, therefore, the sole element that triggered liability of the parent was the proof of a prior request on the subsidiary.

The above provisions of the former draft Statute are correctly described as "the most sweeping parent liability regime proposed so far"¹⁵¹. Insofar as they relieve creditors from enforcement difficulties and evidential obstacles, they can be regarded as a very important legislative effort to link, directly, managerial control which is commonly exercised by the parent company with its liability for the subsidiary's debts.

150. The 1970/1975 draft was significantly amended and substituted by the 1989 proposal for A Council Regulation on the Statute for a European Company (COM(89) 268 OJ C263 16.10.89 p.41), which did not include provisions for groups of companies apart from a conflict of laws rule (art. 114). This rule has been deleted in the revised proposal which the Commission submitted to the Council in May 1991 (COM(91) 174 final OJ C176 8.7.91 p.1). This proposal is still under discussion in a Council Working Group.

151. K. HOFSTETTER, *op. cit.*, p. 588.

iii) The draft proposal for a Ninth Directive

Based on the 1970 Working Report of Professor Hans Würdinger, in 1975 the Commission produced a first draft for a Ninth Directive on groups of companies. This draft was subject to extensive consultations and underwent numerous changes over the years. In late 1984, the latest version was sent for comment to national governments and the Association of Industries within the European Community (UNICE). Most of those invited to comment did not reply¹⁵² and the Commission announced in 1990 its intention not to proceed with a formal proposal¹⁵³.

The purpose of the Directive was clearly stated in its official Explanatory Notes¹⁵⁴:

"In most Member States, existing law on public limited liability company is based on an exceptional state of affairs - namely an economically independent company acting in its own interest. In reality, however, most of these companies maintain links of cooperation with other undertakings, to which they subordinate their interests. The aim of this Directive is to bring the legal position somewhat closer to this reality."

a. The provisions

The draft proposal for a Ninth Directive on groups of companies is greatly influenced by the German *Konzernrecht*. It applies only to groups containing a public limited company as a subsidiary and it distinguishes between four types of groups of companies: *de facto* groups, contractual groups, declaration groups and groups in accordance with national laws.

A *de facto* group exists where an undertaking (the parent undertaking) either:

- a) holds a majority of shareholders' voting rights in another undertaking (the subsidiary undertaking), or,
- b) is a shareholder and has the right to appoint or remove a majority of members of the managerial body of the subsidiary undertaking, or

152. K. BÖHLHOFF & J. BUDDE, *Company Groups - The EEC Proposal for a Ninth Directive in the Light of the Legal Situation in the Federal Republic of Germany*, 6 J. Co. Bus. & Cap. M. L. 1984, p. 163 at 173; K. GLEICHMANN, *op. cit.*, pp. 444-446.

153. Nevertheless, the European Commission's services commissioned a "series of studies which are aimed essentially at tracing the main lines of development that have occurred in several of the Member States since the earlier reports and studies were released. See E. WYMEERSCH (ed.), *Groups of Companies in the EEC: A Survey Report to the European Commission on the Law relating to Corporate Groups in various Member States*, 1993, foreword, p. vi.

154. P. 17.

c) is a shareholder and a majority of the members of the managerial body of the subsidiary undertaking who have held office during the financial year have been appointed solely as a result of the exercise of its rights, or

d) is a shareholder and controls alone, pursuant to an agreement with other shareholders, a majority of the shareholders' voting rights in the subsidiary undertaking¹⁵⁵.

According to art. 7, the managerial body of the subsidiary undertaking shall each year prepare a special report, similar to the German dependency report. The report should give an overall picture of the extent and the intensity of the relationship which existed, directly or indirectly, between the subsidiary company and the parent undertaking during the preceding financial year¹⁵⁶.

Article 9 (1) provides that where a parent company conducts itself as a *de facto* member of the subsidiary's managerial body, it shall be liable to the subsidiary "for any damage resulting from such interference and attributable to mismanagement, under the same conditions as if the undertaking [the parent] were a member of the management body of the company [the subsidiary] and consequently obliged to ensure that the interests of the company are safeguarded". For the purposes of art. 9 (1), "any undertaking which directly or indirectly exercises a decisive influence over decision-making by the management body of a company shall be regarded as a *de facto* member of the management body of that company"¹⁵⁷.

Article 10 provides that proceedings under art. 9 may be brought by the subsidiary itself, by any shareholder or employees' representative acting on its behalf as well as by any creditor of the subsidiary who was unable to obtain satisfaction from it.

Section 5 of the draft Ninth Directive contains provisions applicable to groups of companies linked by agreements whereby one company submits to the management of another¹⁵⁸. By virtue of such an agreement, the controlling undertaking acquires the right to issue instructions to the managerial body of the other company and such instructions shall be complied with¹⁵⁹

155. Art. 2.

156. Art. 7 (2).

157. Art. 9(2).

158. Arts. 13-32.

159. Art. 24.

but they shall be issued with the care of a conscientious director and in the group interest¹⁶⁰; otherwise, the controlling undertaking shall be liable for any resulting damage¹⁶¹.

Art. 29 imposes liability on the controlling undertaking for the obligations of the other party to the contract arising prior or during the contractual period. However, creditors can address their claims against the controlling company only after they have requested payment from the other party to the contract. The controlling undertaking can be relieved of such liability if it proves that the failure by the other party "to fulfil the obligation is attributable to reasons which are not the result of any interference by it [the controlling undertaking] or a failure on its part to intervene¹⁶².

Art. 30 provides that, on the expiry of the contract, the other party to the contract shall be entitled to require the controlling undertaking to make good any diminution in value that the other party has sustained during the contractual period. The controlling undertaking may be relieved of this obligation if it proves that the diminution of value was not the result of its management.

Section 6 of the draft Ninth Directive contains provisions governing groups instituted by unilateral declaration¹⁶³. Where a parent company owns, directly or indirectly, 90% or more of the subsidiary's capital, it can make a unilateral declaration to the subsidiary's management, which shall entail the formation of a group¹⁶⁴. The companies will thereupon be subject to the same liability provisions as contractual groups¹⁶⁵.

Art. 38 allows Member States to introduce into their national laws other provisions concerning the establishment of a group relationship on the condition that the safeguards afforded to minority shareholders and creditors are identical to those contained in the articles of the draft on contractual groups.

Hence, it is only in groups governed by the rules applicable to contractual groups where direct liability is imposed on a parent company without any strict evidential requirement but merely

160. Art. 25.

161. Art. 26(1).

162. Art. 29(2).

163. Arts. 33-37a.

164. Art. 33(1).

165. Art. 35.

upon the conclusion of the contract or upon the unilateral declaration by the parent company. In order to avoid liability, the parent company has to establish that the subsidiary's default is not attributable to the parent's management.

On the contrary, in *de facto* groups, the plaintiff has the onus of proof; he has the difficult task to establish that the parent company, which acted as a *de facto* director of the subsidiary, mismanaged the subsidiary and a damage to the subsidiary was the result of such mismanagement. Although action for liability can be brought by a subsidiary's creditor, the parent company may be held liable only towards the subsidiary and not directly towards the creditor.

Given that integrated groups - which are very similar to declaration groups - and contractual groups are very rarely formed in Germany where the liability provisions are similar to those contained in the draft proposal¹⁶⁶, it seems that the provisions of the draft Directive follow a rather conservative approach on the issue of parental liability, especially in comparison with the provisions contained in the former draft for a European Company Statute.

This may be partially explained by the fact that, whereas the former draft for a European Company Statute intended to provide an optional legal framework for groups of companies, the Draft Ninth Directive would require the Member States to shape their national laws in accordance with its provisions.

In any case, the latest official opinion on the fate of the Directive is that there is no sign that any further steps will be taken in the foreseeable future¹⁶⁷.

b. The reaction to the Directive

From the early stages of the preparation of the draft, the business associations of each Member State except Germany disputed the notion and the necessity of harmonized legislation on groups of companies¹⁶⁸. In its comment to the 1980 draft proposal, UNICE stated:

"... the Commission has not adduced any evidence that the development of groups has been hampered by existing company laws, and indeed the contrary

166. See *supra*, under A, ii, a and b.

167. DTI, *The Single Market, Company Law Harmonisation*, August 1992, at p. 15; in a contact which we had with the Companies Division of DTI on 17 March 1993, it was confirmed that this position has not changed.

168. K. BÖHLHOFF, J. BUDDE, *op. cit.* For the French point of view, see Y. GUYON, *Examen critique de projets européens en matière des groupes de sociétés*, in K. HOPT (ed.), *op. cit.*, p. 155 *et seq.*; R. HOUIN, *op. cit.*, p. 57.

would seem to be demonstrated by the fact that nine out of ten Member States have not considered it necessary to introduce a system of group law. UNICE considers that company law in the various Member States has hindered neither the formation of groups of companies nor their proper functioning."¹⁶⁹

The British view on the latest draft was summarized in the following words of the Law Society's Standing Committee on Company Law:

"We believe that in its present form the draft proposal remains unsatisfactory and that its effects would be unpredictable, and it appears to us that there is confusion as to its aims."¹⁷⁰

The fundamental objection of the Committee was that the draft sought to lay down a rigid set of rules to cover an infinite variety of circumstances:

"Some flexibility is certainly essential because of the ways in which groups operate in practice. Some groups are operated as if the subsidiaries were divisions of the parent company, and in such cases all important decisions are made by the parent company. In other groups (even if the legal relationship is precisely the same) the subsidiaries have virtual autonomy."¹⁷¹

As far as the provisions on contractual groups were concerned, the requirement that a group relationship can be formally established by a control contract between the controlling and the dependent company was criticized in business circles for excessive formalism. According to this view, a parent company which already controls its subsidiary through a majority shareholding has no reason to enter into a contract with the subsidiary¹⁷².

A greater deal of criticism was directed against the provisions on *de facto* groups. It was argued that detrimental influence on a subsidiary's management by the parent is rare, and, therefore, the draft is "taking a sledgehammer to crack a nut"¹⁷³. The Law Society, especially, argued that the assumption that most public limited companies maintain links of co-

169. UNICE 1981 Comment, dated April 23, 1981, A 1 and 2.

170. The Law Society, European Communities Draft Ninth Company Law Directive on the Conduct of Groups containing a Public Limited Company as a Subsidiary, Memorandum by the Society's Standing Committee on Company law, October 1985, Part I, para. 1.3.

171. The Law Society, *op. cit.*, Part II, para. 2.4.

172. K. GLEICHMANN, *op. cit.*, p. 448.

173. *Ibid.*, p. 453.

operation with other undertakings to which they subordinate their interests, is not valid¹⁷⁴. It was also argued that the work required in the preparation of the dependency report imposed a heavy administrative burden¹⁷⁵ and that the publication of the report may "well involve disclosure of trade practices and trade secrets which are properly considered confidential"¹⁷⁶.

Dr. Gleichmann, who was responsible for the preparation of the draft proposal within the Directorate General of the EC Commission for Internal Market and Industrial Affairs, answered to the criticisms by pointing out that what the Directive sought to do was to ensure that absence of subordination is the normal pattern; but when, in a particular case, the pattern is different, the subsidiary company and those with interests in it should be protected by means of appropriate rules to prevent or compensate for damage¹⁷⁷.

Referring to the dependency report, he pointed out that if detrimental transactions or measures rarely take place, as the critics argue, the work involved in the preparation of the report would be minimal and trade secrets would only be at risk in very few cases. If, on the contrary, in the majority of the cases there is a great number of such transactions and measures to report, the protection of the subsidiary and its shareholders and creditors would greatly outweigh any administrative burden and the interest of the controlling company in keeping such transactions secret¹⁷⁸.

Another major objection raised especially by the Committee of the Law Society was that article 9 appeared to impose a "wide ranging liability" for the mismanagement of the subsidiary of a *de facto* group¹⁷⁹. Moreover, there was no definition of "mismanagement" and the definition of the *de facto* manager was considered extremely vague¹⁸⁰. In the discussions between the Committee and Dr. Gleichmann, the latter admitted that the word mismanagement was too extensive and perhaps, misleading. It was not intended to make *de facto* directors liable simply for inefficiency or for making management decisions which subsequently turned out to be

174. The Law Society, op. cit., Part III, para. 4.1.

175. K. GLEICHMANN, op. cit., p. 453.

176. The Law Society, op. cit., Part III, para. 4.2.

177. K. GLEICHMANN, op. cit., pp. 453-454.

178. Ibid., p. 453.

179. Supplementary Memorandum by the Law Society's Standing Committee on Company Law, May 1986, p. 1.

180. The Law Society, op. cit., Part III, paras. 4.6 and 4.7.

wrong. On the other hand, he felt that the expression "breach of duty" which was suggested by the Committee, would be too restrictive¹⁸¹.

The Law Society's Standing Committee on Company Law proceeded also in the formulation of an alternative proposal for groups of companies¹⁸². It suggested that it might be desirable to allow companies to choose whether to declare themselves a group or not. If companies decided to act as a group (or if the parent company declared that they would act as a group), then such problems as the maintenance of capital, the terms of trading within the group, the solvency or insolvency of any individual subsidiary and the question of cross-guarantees would become irrelevant. The parent (or the group jointly and severally) should perhaps then become liable for all the group obligations.

If it was decided not to declare group status, then neither the parent company nor any of the subsidiary companies would be liable for each other's obligations. They would, however, then be treated as completely independent legal bodies. The directors would have a duty to behave responsibly in the interests of the individual company of which they were directors, and without regard to the interests of other members of the group. If this solution were adopted, groups would be required to state what alternative applied, so that investors and creditors could act accordingly as they thought fit¹⁸³.

However, as the experience of the minimal practical application of the German provisions on contractual or integrated groups has showed, this solution does not offer any realistic chance of protecting effectively creditors of a subsidiary. Companies will have to declare whether or not they constitute a group, and, in the absence of substantial tax or other incentives, they will have no reason to do so. Moreover, many of the problems related to groups will still remain unresolved for those companies which elect, for whatever reason, not to declare group status.

181. Supplementary Memorandum, *op. cit.*, pp. 1-2.

182. The Law Society, *op. cit.*, Part II, para. 2.7.

183. For a brief commentary on this proposal, see FR. WOOLDRIDGE, *Aspects of the Regulation of Groups of Companies in European Laws*, *op. cit.*, p. 129.

D: CONCLUSION

From the foregoing overview of the German, French and European Community approaches to the issue of the liability of the parent company for the debts of its subsidiary, it appears that whenever liability is imposed on the parent, this is done mainly on the ground of the parent's managerial control over the subsidiary.

In general, two different approaches are developed. According to the first approach, the group of companies is not formally recognized as a unit of business organization and liability may be imposed on the parent company only in cases where the parent has mismanaged the subsidiary and this mismanagement resulted in a detriment to the subsidiary. The mere establishment of the parent's control over the subsidiary does not suffice. The French articles 180 and 182 of the law of 25 January 1985 as well as the German and the Ninth Directive provisions on *de facto* groups fall into this category.

The alternative approach is adopted by the German *Konzernrecht*, in the provisions on integration and contractual groups, and by the Ninth Directive, in the provisions on declaration and contractual groups. By virtue of these provisions, the group of companies is formally recognized as a unit of business organization and liability is imposed on the parent company upon the formation of the group, i.e. upon integration or declaration or upon the conclusion of a control contract. This liability is imposed as a corollary of the broad authority of the parent company to direct its subsidiary and to subordinate the subsidiary's interests to its own.

Between these two approaches stands the French concept of *apparence*. According to this concept, a third party may invoke the apparent state of affairs in order to impose liability on the parent company, whenever the parent's interference with the management of its subsidiary creates the impression of operation of one single entity.

Similar was the effect of the German qualified *de facto* group concept before the decision of the Supreme Court in TBB¹⁸⁴. In a qualified *de facto* group, the parent company has an extensive and systematic involvement in the subsidiary's affairs. In these circumstances, a rebuttable presumption existed that the parent had not shown sufficient consideration for the interests of the subsidiary. Accordingly, the parent could be held liable for the subsidiary's obligations, unless it could defend itself successfully. However, by virtue of TBB, the presumption has

184. See *supra*, under A, iii.

been abandoned and the burden of proof is now placed on the plaintiff; this burden will be reduced where the plaintiff lacks insight into the internal affairs of the group.

According to the former draft for a European Company Statute, a group was formed where the subsidiary was under the unified management of the parent, and a dependent company was rebuttably presumed to form a group with the controlling company. Upon establishment of the group relationship and proof of a prior request on the subsidiary, a parent company could be held directly liable to a subsidiary's creditor.

Since integration, declaration and contractual groups are unlikely to become the typical group structure, the qualified *de facto* group concept, especially in its earlier version, and the former draft for a European Company Statute seem to set forth the most realistic and radical parent liability regime proposed so far. For liability to be imposed only one element has to be established: the submission of the subsidiary to the managerial control of the parent, either in the form of extensive and systematic managerial interference or in the form of unified management. In this case, the rationale for imposing liability on the parent company is the power of the parent company to subordinate the subsidiary's interests to its own or to the interests of the group as a whole.

CONCLUDING CHAPTER

i) Parental liability: an issue unresolved

The Cork's Report chapter on Group Trading started as follows:

"Group activity in the sense of the conduct of various businesses by a holding company through a number of subsidiaries is a Twentieth Century phenomenon. The principles of our company law and of our insolvency law were developed in the Nineteenth Century. It is not surprising, therefore, that some of the basic principles of company and insolvency law fit uneasily with the modern commercial realities of group enterprise."¹

On the issue of holding the parent company responsible for the debts of its insolvent subsidiary the Report concluded:

"The matter is of such importance and of such gravity that there should be the widest possible review of the different considerations, with a view to the introduction of reforming legislation within the foreseeable future. We would wish to see such a revision undertaken as a matter of urgency."²

More than a decade after, a revision of the relevant existing law has not yet been undertaken and the principle of limited liability seems still to fit uneasily with the modern commercial realities of group enterprise. The area of liability is still an area where the legislature and the courts have not made any steps of adaptation to the reality of the group. The privilege of limited liability is invariably granted to the parent company, as an attendant of the legal separation between parent and subsidiary. Whereas, in the overwhelming majority of cases, a parent company with its subsidiaries conduct their operations as integral parts of the same economic unit, for liability purposes, they are treated as separate legal entities.

1. Insolvency Law Review Committee, *Insolvency Law and Practice*, Cmnd. 8558 (1982), Chap. 51, para. 1922.

2. *Ibid.*, para. 1952. For the different proposals which were put to the Committee for reform, see paras. 1934-1935.

However, the rule of limited liability did not emerge as a necessary attendant of the separate entity concept but as a legal means of achieving economic goals. The available evidence³ on the origins of limited liability suggests that limited liability was originally designed to facilitate the organization of businesses requiring more capital that could be available from one or a small number of individuals. Limited liability was considered necessary to stimulate investment by assuring investors that their risk would be limited to their investment.

The model of corporation inherent in the first statutes introducing the modern type of company with limited liability was a single and independent company consisting of a considerable number of members. To these members the protection afforded by limited liability was particularly welcome since the company was controlled by others.

At the time when limited liability was statutorily introduced, i.e. almost one and a half centuries ago, the economic reality was totally different from the modern reality which is characterized by the predominance of groups of companies. It was neither intended nor contemplated that limited liability might protect corporate shareholders and apply to a typical group situation where subsidiaries are, almost invariably, wholly-owned and uniformly managed by their parent⁴.

In accordance with the origins of limited liability, a basic economic analysis of the rule suggests that limited liability is not particularly advantageous in the raising of capital by companies owned and controlled by the same persons such as one-man companies and, especially, wholly-owned subsidiaries⁵. In these companies, limited liability does neither stimulate great amounts of investment nor greatly contributes to the minimization of the costs. Its only remaining effect is that it transfers uncompensated risks to the company's creditors thereby producing a social cost without producing a countervailing social benefit.

Therefore, to give a satisfactory solution to the issue of group liability one has to depart from the principle of the strict association between corporate personality and limited liability. The strict adherence to this principle as a result of the decision in *Salomon*⁶ has meant that the issue of the liability of the parent for the debts of its subsidiary has not adequately been addressed either by the legislature or by the courts.

3. See *supra*, ch. I.

4. See *supra*, ch. III.

5. See *supra*, chs. II, IV.

6. See *supra*, ch. VI, A.

ii) Judicial v. legislative solution

In fact, for other than liability issues, the group relationship is not totally ignored. The Companies Act 1985 defines the holding-subsidary relationship for many purposes including accounting. The definition for other than accounting purposes is relevant for provisions such as s. 23 which prohibits a subsidiary company from acquiring shares in its holding company, ss. 151 to 154 on the provision of financial assistance in the purchase of a company's shares and ss. 320 to 342 on substantial transactions between directors and their companies and on loans by companies to their directors⁷. Without a specific reference to the group relationship, these provisions treat parent and subsidiary companies as companies between which a *sui generis* relationship exists.

On the judicial side, the courts have often been called upon to decide issues other than liability in cases involving groups of companies. In some instances, the separate legal personalities of parent and subsidiary have been respected, whereas in some others the group relationship has been recognized with various consequences⁸. However, there has been such a lack of consistency in the principles applied and the decisions reached that the attitude of the courts in a particular case cannot be predicted with any degree of certainty.

The only safe conclusion that might be drawn is that the courts may be apt to ignore the legal separation between parent and subsidiary on the ground of the parent's extensive control over the subsidiary. There is a discernable judicial conviction that parent and subsidiary should not be treated as distinct legal persons when the subsidiary is so closely controlled and directed by the parent company that it can be described as the parent's agent or the two companies can be described as constituting a single economic unit.

It might be suggested that courts should make similar use of the criterion of extensive parental control in cases where the issue at stake is the liability of the parent for the debts of its subsidiary. Since the courts are ready to depart from the strict corporate entity principle on the basis of the parent's extensive control over the subsidiary, they can also depart from the limited liability rule in similar circumstances.

Professor Schmitthoff suggested that courts should develop a rebuttable presumption that a parent employs its controlled subsidiaries as agents, and in these circumstances the parent

7. See *supra*, ch. VII, A.

8. See *supra*, ch. VI, B and C.

company should be liable for the subsidiaries' debts. If a subsidiary is wholly-owned there should be a conclusive presumption that it is controlled by the parent and if the parent holds more than 50% of the voting power of the subsidiary but does not own the subsidiary wholly, there should be a rebuttable presumption to the effect that the subsidiary is controlled⁹.

It is extremely doubtful, however, whether the courts will readily adopt such a suggestion. It is likely that courts would be ready to adopt such a suggestion in cases involving issues other than liability; for instance in cases involving taxation or anti-trust issues¹⁰. Where, however, the issue at stake is the liability of the parent for the debts of its subsidiary, it seems that there is no space for such an adoption.

The dictum of Lord Macnaghten in Salomon v. Salomon¹¹ still constitutes a fundamental principle in English company law:

"The company is at law a different person altogether from the subscribers to the memorandum; and though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act."

Ninety years later, the judicial approach has not been altered. In J.H. Rayner (Mincing Lane) Ltd. v. Department of Trade and Industry¹², Kerr L.J. defended the perennial validity of the Salomon doctrine:

"The crucial point on which the House of Lords overruled the Court of Appeal in that landmark case was precisely the rejection of the doctrine that agency between a corporation and its members in relation to the corporation's contracts can be inferred from the control exercisable by the members over the corporation or from the fact that the sole objective of the corporation's contracts was to benefit the members. **That rejection of the doctrine of agency to impugn the non-liability of the members for the acts of the corporation is the foundation of our company law [my emphasis].**"

9. CL. SCHMITTHOFF, *The Wholly Owned and the Controlled Subsidiary*, [1978] J.B.L., p. 218 at 224-229.

10. See *supra*, ch. V.

11. [1897] A.C. 22 at 51; see *supra*, ch. VI, A.

12. [1988] 3 W.L.R. 1033; see *supra*, ch. VI, A.

The rigidity of the courts on this issue was manifest in the two recent cases where the real issue at stake was the imposition of liability on the parent company, namely the *Multinational* and the *Cape Industries* case¹³. In these cases, despite the existence of evidence that the subsidiaries were under the close control and direction of the parent company, the courts refused to infer an agency or an economic unity relationship; they remained strictly adhered to the Salomon doctrine and essentially upheld the application of the limited liability rule in a group situation. From the attitude of the courts in other group cases, it seems that, if the issue at stake in *Multinational* or *Cape Industries* had not been the liability of the parent, the courts would not have hesitated to infer an agency or an economic unity relationship even on the basis of the same evidence¹⁴.

Hence, the present state of case law is heavily dominated by the strict association between the entity doctrine and the limited liability privilege. It is unlikely that the courts will be ready to depart from the dominant trend and to solve the parental liability issue in the lines suggested by Professor Schmitthoff. In the absence of any strong authority to the contrary effect, the courts will feel bound to hold that the parent company is a distinct person from its subsidiary and, as such, it cannot be held liable for the subsidiary's obligations. The very few instances where the courts might decide otherwise cannot substitute for a clear legal principle.

Thus, a satisfactory and realistic solution to the problem cannot be expected from the courts. The other possibility is for the legislature, and not the courts, to intervene and to resolve the issue of the liability of the parent for the debts of its subsidiaries. The legislature is not bound by any judicial precedent and can develop the principle of the parent's liability on a totally novel basis while preserving the existing liability principles for independent companies¹⁵. A legislative solution has also the advantage of being more compatible with a future Community initiative in the area and, in fact, the latter could constitute the basis for such solution.

13. See *supra*, ch. VI, B.

14. See *supra*, ch. VI, C.

15. A legislative solution has been preferred in New Zealand. Section 315A of the Companies Act 1985, inserted by virtue of the Companies Amendment Act 1980, confers upon the courts the discretion to order, in the course of the insolvent winding up of one group company, that any other group company shall pay the first company's debts, if this is considered just and equitable. The courts, in exercising their discretion, are required to have regard to the extent to which the related company took part in the management of the company being wound up, to the conduct of the related company towards the creditors of the company being wound up and to the extent to which the winding up is attributable to the actions of the related company. See Cork Committee, *op. cit.*, paras. 1947-1950; R.S. NATHAN, *Controlling the Puppeteers: Reform of Parent-Subsidiary Law in New Zealand*, 3 *Cant. L. Rev.* 1986, p. 1, at 16; FR. WOOLDRIDGE, *Aspects of the Regulation of Groups of Companies in European Laws*, in R.R. DRURY & P.G. XUEREB (ed.), *European Company Laws*, 1990, p. 103, at 128.

iii) Control as the triggering element

Any legislative solution should have three characteristics; it should be (a) reasonable, (b) workable and (c) fair. To be reasonable, it should reflect the economic realities of the group of companies. To be workable, it should employ clear and ascertainable terms and should not be subject to very strict requirements. To be fair, it should take into account all the interests involved in a group of companies.

The economic realities of the group will be reflected in the rule under consideration only when the parent is deprived of its limited liability for the debts of its subsidiary in appropriate circumstances. To legislate that a parent company shall in every case be liable for the debts of its subsidiary, is unreasonable. There are groups where the parent company has no links with its subsidiary apart from the links arising from the holding of the majority or all of the subsidiary's shares. This will almost invariably be the case of a holding company which does not pursue any activity of its own but whose only function is to serve as a link between its shareholders and the subsidiaries; it will normally be the case of an institutional investor who invested in the shares of the subsidiary simply because it considered it to be a sound investment; it will sometimes be the case of the parent company of a conglomerate group where the subsidiaries carry on businesses commercially and unrelated to each other¹⁶. In these circumstances, no reasonable explanation can be given for why the parent company should become responsible for its subsidiaries' obligations.

However, as it was evidenced in our small survey¹⁷, in the overwhelming majority of the cases, the parent has links with its subsidiaries which go beyond the links normally existing between a majority shareholder and his company. The parent company does not restrict itself to a mere shareholding role but it becomes the actual manager of the subsidiary in crucial aspects of the subsidiary's operation. Decisions on the general policy and on major issues for the subsidiary are taken by the parent itself or at the parent's behest with a view to the profitability of the group as a whole. It is reasonable that, in these circumstances, the parent company should become liable for the obligations of its subsidiary, at least for those obligations which were within the scope of such parental control.

The exercise of parental control in the above manner is the critical element which should trigger the liability of the parent company. In fact, this was the element relied upon by the courts in

16. R.R. PENNINGTON, *Pennington's Company Law*, 6th ed., 1990, p. 730.

17. See *supra*, ch. III, B.

those cases where the legal separation between parent and subsidiary companies was not given full effect¹⁸. However, the imposition of liability on the basis of such control seems to be at variance with the modern trend of allowing the operation of one-man companies with limited liability. Section 24 of the Companies Act 1985, as amended by the Single Member Private Limited Companies Regulations 1992, explicitly confers the privilege of limited liability on the sole member of a private company¹⁹. Like a parent company which owns 100% of the subsidiary's capital, a sole individual owner is expected to exercise absolute control over his company's operations. To protect him with limited liability and to deny limited liability to the parent company seems to constitute unfair treatment of the parent company.

However, there is a substantial difference between the control exercised by a single proprietor who incorporates his business in order to achieve limited liability and the control exercised by a parent company which conducts its operations through a number of subsidiary companies. The typical single proprietor who has no business interests outside his company, directs his company's operations to the achievement of the largest possible return on his investment. Insofar as he does not pursue any economic activity which is distinct from that of the company, maximization of his return can be achieved only when the company is managed according to its own interests. It is a ludicrous point to argue that the company is not managed according to its own interests because of the payment of dividends to the sole shareholder since the expectation for financial return on the amount invested is inherent in the nature of the company as a capital-raising device.

The situation in a group is different. Within a group, the company does not constitute a distinct economic unit but it is only the legal framework for part of a larger economic unit. The company's own interests are not paramount but are subordinate to the interests of the group. Normally, the real purpose behind the segmentation of an enterprise into several constituent companies is maximization of return. Insofar as maximization of return from the group as a whole can be served by operating one company at a loss or by artificially depressing its profits for tax or other purposes, there is a potential conflict between the interests of the particular company and the group as a whole.

Thus, a parent company which itself pursues an economic activity, may have an incentive to depart from the norms of management generally observed by a rational individual investor. A parent company may need to apply the financial resources of a subsidiary in accordance with

18. See *supra*, ch. VI, C.

19. See *supra*, ch. VII, B, i, c.

the strategy and priorities of the group as a whole, without regard to the individual interests of the subsidiary. Free commingling of funds and properties within the group and depletion of the assets of a particular subsidiary may be highly desirable in order to achieve maximization of return from the group as a whole. Thus, when deciding on crucial issues for a subsidiary, the parent company is unavoidably influenced by the consideration of interests which may conflict with the subsidiary's own interests.

Preservation of limited liability in the case of a one-man company or a company owned by a few individuals is based on the notion of the company as a legally and economically independent unit acting in its own interest. Even where one shareholder holds the majority or all the shares of the company or he can by other means influence in a decisive manner the composition of the company's organs, this assumption, that the company is acting in its own interests, is, in principle, correct.

In the case of a subsidiary, however, the assumption of an independent company acting in its own interest is fundamentally false. In this case, the correct assumption is that the subsidiary is economically dependent on the parent company whose interests may conflict with the interests of the subsidiary. Preservation of limited liability in these circumstances may be extremely prejudicial to the interests of the subsidiary's creditors who may only have a claim on the assets of the subsidiary notwithstanding the fact that these assets may have been used at the behest and in the interests of the parent company.

Thus, liability should be imposed on the parent company not merely because the subsidiary is closely controlled by the parent but because the exercise of control is potentially directed to the service of the parent's interests which may be in conflict with the subsidiary's own interests.

iv) The need for a definition of the group

A rule for the liability of the parent would be incomplete if it is not accompanied by a new definition for the group of companies. The present definition of holding and subsidiary companies for general purposes (CA 1985, s. 736) relies exclusively on formal criteria such as the parent's holding of the majority of voting rights in the subsidiary or the parent's power to appoint directors holding the majority of voting rights in the subsidiary's board. According to this definition, a parent-subsidiary relationship is established when the parent has the legal means to exercise control over the subsidiary.

However, as has already been mentioned, the parent company should assume liability for its subsidiary not because it can exercise the control exercisable by any majority shareholder but because the control actually exercised entails a submission of the subsidiary's interests to the interests of the parent. Thus, liability on the parent company for the debts of its subsidiary cannot be imposed merely on the basis of the criteria employed by the existing definition of the parent-subsidiary relationship. The question of control must be investigated.

The provisions on group accounting have introduced definitions for parent and subsidiary undertakings (CA 1985, s. 258) which are applicable only for accounting purposes. Likewise, a provision on parental liability can introduce a definition for the group of companies which will apply only for the purposes of this provision. This definition should describe the group as the relationship between parent and subsidiary and should, additionally, contain the element which distinguishes this relationship from the relationship of a majority or sole shareholder to his company, i.e. the potential submission of the subsidiary's management to the parent's own interests.

It is difficult to find a term which accurately denotes that the subsidiary is no more managed as an independent entity and that its interests are potentially subordinated to the interests of its parent company. The "unified management" term which is used in the German definition of the group²⁰, in the former draft for a European Company Statute²¹ and in the English definitions of the parent-subsidiary relationship for accounting purposes²², could be a possible solution insofar as it denotes that the subsidiary company is no more managed as an independent company²³.

Unified management may be said to exist when there is a high degree of integration of the subsidiary into the strategy of the parent. It is not necessary that the parent does determine all the decisions taken by the subsidiary. It suffices that it establishes general guidelines for the subsidiary and determines the subsidiary's policy in relation to its main functions. Such

20. AktG, art. 18; see *supra*, ch. VIII, A, i.

21. Art. 223; see *supra*, ch. VIII, C, ii.

22. CA 1985, s. 258 (4); see *supra*, ch. VII, A, i.

23. It is argued, however, that a general concept such as that of unified management, without further detailed specification, is something to which English lawyers, particularly those in the commercial field, would take strong objection because "they are very hostile to commercial legislation containing open textured concepts". D.D. PRENTICE, A Survey of the Law Relating to Corporate Groups in the United Kingdom, in ED. WYMEERSCH (ed.), *Groups of Companies in the EEC, A Survey Report to the European Commission on the Law relating to Corporate Groups in various Member States*, 1993, p. 279, at 287.

functions will primarily include financial planning and control as well as appointment of senior management²⁴.

Thus, the definition of the group should be as follows:

"A group is formed between a parent company and one or more subsidiaries if the subsidiaries are under the unified management of the parent company. For the purposes of this provision a subsidiary company is under the unified management of the parent company when it is not managed as an independent company."

v) The two alternatives

The element of unified management shall be the element that triggers the liability of the parent company. There are two alternatives here:

- (1) To impose liability merely upon establishment of the group relationship, i.e. upon establishment of the parent's unified management. The unified management of the parent can either be presumed or be based on factual evidence; or
- (2) To impose liability upon evidence that the parent has in a particular case disregarded the interests of its controlled subsidiary, i.e. the parent's unified management resulted in a detriment for the subsidiary.

The first alternative reflects more accurately the rationale for imposing liability on the parent company. Liability is imposed on the parent as a corollary of the parent's direction of the subsidiary's affairs according to the group's overall or the parent's own interests; it is not imposed as a compensation to the subsidiary or its creditors for a detriment attributable to the parent's mismanagement.

The first alternative rightly proceeds upon the assumption that the subsidiary cannot be compared to an independent company. There is no need to establish that the unified management of the parent caused the detriment complained of since the potential conflict of interests between parent and subsidiary company implies that a detriment to the subsidiary will arise whenever the parent resolves a particular conflict in its own interests and contrary to the subsidiary's interests.

24. For similar definitions of unified management, see K. GLEICHMANN, *The Law of Corporate Groups in the European Community*, in D. SUGARMAN & G. TEUBNER (ed.), *Regulating Corporate Groups in Europe*, 1990, p. 435 at 441; FR. WOOLDRIDGE, *Groups of Companies: The Law and Practice in Britain, France and Germany*, IALS, 1981, pp. 52-53.

Although this alternative seems to be burdensome for parent companies, it has another important advantage. It relieves plaintiffs from the heavy task of establishing that it was the unified management of the parent company which caused the detriment to the subsidiary. This requirement would render the provision highly impracticable, since there will be cases where the cause of a particular loss cannot be identified without significant delay and expense. It would only be the powerful and sophisticated lending institutions which could bear the costs of such litigation. On the contrary, the majority of creditors would hesitate to bring an action which requires high litigation costs and the outcome of which is, at best, uncertain.

Hence, the following subsection should be added to the provision:

"A parent company shall be liable for the debts of its subsidiary with which it forms a group."

vi) Unified management: presumption v. evidence

It is already stated that unified management may be said to exist when the subsidiary is no longer managed as a independent legal entity but has surrendered its autonomy in respect of its most crucial functions to the parent company. Given that the most important functions of a subsidiary such as investment, financial planning and control as well as the appointment of senior personnel are, almost invariably, under the authority and within the decision-making power of the parent company²⁵, it is reasonable to relieve creditors of the heavy task of establishing unified management. Instead, a presumption should be created to the effect that a parent company exercises unified management over its subsidiary.

This presumption should not be irrebutable. A subsidiary company may constitute part of a larger economic unit but may still conduct its operations as an independent company. This will particularly be the case where the subsidiary company constitutes either a genuine expansion of an existing business into a new field, or a genuine means of insulating a part of a larger economic unit from risks of other parts where the separate parts might exist as separate businesses, or a necessary means to comply with local legal or administrative requirements.

In these circumstances, separate incorporation with limited liability conforms with economic reality and creditors of the subsidiary should, in principle, be denied access to the assets of the parent company. Thus, the presumption of unified management could be rebutted by the parent company by showing that it (the parent) restricted itself to a mere passive shareholder role with the effect that the subsidiary conducted its operations as a genuine independent company.

25. See *supra*, ch. III, B, ii, c.

Hence, the following subsection should be added to the provision:

"A subsidiary company shall be rebuttably presumed to be under the unified management of its parent company. The parent company may rebut this presumption if it establishes that it restricted itself to a mere passive shareholding role."

The provision may then lay down a number of factors which will be relevant in determining whether the subsidiary is under the unified management of the parent or whether the parent restricted itself to a mere passive shareholding role. These factors may include:

1. Whether the parent company pursues its own economic activity or it is a mere holding company having no real function apart from being used as a link between its shareholders and its operating subsidiaries.
2. Whether the parent company is an institutional investor not actively participating in the subsidiary's management but interested only to protect its investment in the subsidiary.
3. If the parent carries on its own economic activity, whether this activity is identical, complementary or totally irrelevant to the activity pursued by the subsidiary. Unified management is more likely to exist when parent and subsidiary operate in the same industry or their operations are complementary to each other, e.g. the parent manufactures the products which are distributed by the subsidiary.
4. Whether the subsidiary is adequately capitalized to carry on the particular activity or is dependent on resources provided by the parent by the way of secured loans.
5. Percentage of shareholding and extent of interlocking directorships. Although such factors cannot be determinant, they may be of such numbers that they cannot be ignored. If, for instance, the subsidiary is wholly-owned and its board is identical with the board of the parent, there is a strong case for considering the subsidiary to be under the parent's unified management. However, in the absence of such factors, the contrary should not be concluded.

This list of factors should not be conclusive. The courts should be given discretion to take into account other factors in determining whether the subsidiary is under the unified management of the parent. Hence, case law may develop the concept of unified management and clarify the economic circumstances where the parent company should be liable for the subsidiary's debts.

The solution of the rebuttable presumption of unified management has the important advantage of relieving plaintiffs of the heavy task of establishing the necessary degree of the parent's interference with the subsidiary's management. Relevant is the experience of the English provisions on fraudulent and wrongful trading²⁶ and the French provisions of arts. 180 and

26. *Supra*, ch. VII, B, ii and iii.

182²⁷, which require that the plaintiff establishes the parent's involvement in its subsidiary's affairs or the parent's status as the subsidiary's shadow director. This requirement significantly impairs the applicability of these provisions, and, to a certain extent, explains their minimal application in cases involving parent and subsidiary companies.

The rebuttable presumption of unified management enables the plaintiff to sue the parent company merely upon establishment of the parent-subsidiary relationship and proof of a prior request on the subsidiary. Once the parent-subsidiary relationship is established according to already existing definitions, and the plaintiff produces evidence of the subsidiary's failure to satisfy him, the parent becomes liable for the subsidiary's debt unless it (the parent) rebuts the presumption of unified management.

It will certainly be easier and cheaper for the parent company to rebut the presumption than it would be for the plaintiff to establish unified management. Generally, a parent company is expected to have a better insight into the operations of the whole group and easy access to information about the managerial pattern followed in respect of a particular subsidiary. All the relevant documents and other evidence will either be under the parent's own possession or, at least, will be easily obtainable.

On the contrary, a plaintiff seeking to establish that the subsidiary is under the unified management of the parent is going to face great difficulties. It would be extremely difficult for him to locate the relevant evidence and even then, this evidence might not be obtainable. Even a sophisticated creditor such a financial institution, would have to incur very substantial costs in order to bring an action against the parent company with a serious possibility of success. For a small trade creditor, and, *a fortiore*, for a tort creditor, the size of their claim compared to the high litigation costs required would rarely, if ever, justify commencing legal proceedings.

An example of the difficulties that the plaintiff might face in establishing the unified management of the parent is the decision in Lonrho v. Shell Petroleum Ltd.²⁸. In that case, the plaintiff sought an order for discovery of certain documents which it claimed were within the "possession, custody or power" of the defendant company operating as a joint venture between Shell and BP. These documents were held by the wholly-owned and controlled South African subsidiaries of Shell and BP and were relevant in the litigation against the defendant. The court refused to grant an order on the grounds that the documents were under the control

27. *Supra*, ch. VIII, B, iii.

28. [1980] 1 W.L.R. 627, HL.

of the defendant's subsidiaries which were separate and distinct legal entities and the defendant had no enforceable legal right to obtain inspection of the documents.

vii) Nature of liability and persons entitled to sue

If the parent fails to rebut the presumption of unified management, it shall be liable for a debt of its subsidiary, but only after the plaintiff produces evidence that he failed to obtain satisfaction from the subsidiary itself. The liability of the parent company for the debts of the subsidiary shall thus be in the form of a guarantee. The plaintiff must first proceed against the subsidiary, and only if he fails to obtain satisfaction, will he become able to proceed against the parent company. This requirement ensures that the parent company will not be the primary target of all those subsidiary's creditors who do not want to gamble on the possibility of obtaining satisfaction by the subsidiary itself. Creditors of the parent company will also be, to a certain extent, protected, since the assets of the parent company will be available to creditors of its subsidiary only after the subsidiary's assets have been exhausted.

The protection afforded to subsidiary's creditors would be incomplete without giving them the right of a direct action. Any person who has an enforceable claim for a sum to be paid by the subsidiary can direct his claim against the parent if the subsidiary does not meet its obligation within a certain period after the claim became enforceable. Thus, the parent company shall become liable to pay the sum and the claim shall be enforceable against the parent company²⁹. This solution relieves creditors from the expensive task of initiating liquidation proceedings in order to call upon the parent company to meet the liabilities of its subsidiaries, as is the case under the provisions on fraudulent and wrongful trading.

The complete provision could thus be as follows:

1. A parent company shall be liable for the debts of its subsidiary with which it forms a group.
2. A group is formed between a parent and one or more subsidiary companies if the subsidiary companies are under the unified management of the parent company. For the purposes of this provision, a subsidiary company is under the unified management of the parent company when it is not managed as an independent company.

29. In this respect, a similar proposal was put forward by the spokesman for the Labour Party during the debates on the Companies Act 1980, Parliamentary Debates, House of Commons Official Reports (Hansard), vol. 979, 1980, cols. 1249-1250. The proposed clause 7 (1) on the liability of a holding company for its defaulting subsidiary read as follows:

"... if any sum required by any judgment or order to be paid by a company which is a subsidiary of a holding company is not paid by the company concerned within the period of fourteen days beginning on the date on which the judgment or order becomes enforceable by execution or (in Scotland) by diligence, the holding company shall be liable to pay that sum and that judgment or order shall be enforceable against the holding company accordingly."

3. A subsidiary company will be rebuttably presumed to be under the unified management of its parent company. The parent company may rebut this presumption if it establishes that it restricted itself to a mere passive shareholding role.

4. Proceedings against the parent company may be brought by any person having an enforceable claim against the subsidiary company, only after that person has first proceeded against the subsidiary and failed to obtain satisfaction.

viii) Possible objections to the proposal

It may be objected that such a provision entails a preferential treatment for the subsidiary's creditors and is extremely burdensome for parent companies. Particularly, it might be argued that under such a provision parent companies would refrain from taking socially useful risks through their subsidiaries. In the absence of the limited liability of the parent company, some worthwhile but risky adventures would not be undertaken at all since a failure of the particular adventure might threaten the solvency of the entire group.

However, even under a provision depriving the parent company of the privilege of limited liability in the above circumstances, parent companies may still undertake a socially worthwhile risk by incorporating a subsidiary over which they exercise the control normally exercised by the typical majority shareholder. If there is evidence suggesting that the subsidiary is treated as a separate entity, namely that it is not excessively dependent on its parent, it has an adequate capitalization to carry out its business, it is organized and managed in a way that ensures a realistic potential for profitability, the parent should by no means be held liable for the subsidiary's obligations. If, however, the subsidiary is not treated as a separate entity in the above manner, and, additionally, its operations generate losses for third parties, separate incorporation with limited liability should not be protected at the expense of creditors and the society at large.

It might also be argued that there is no necessity for legislating on the liability for the parent for the debts of its subsidiary since, as a matter of practice, parent companies always stand behind the obligations of their insolvent subsidiaries. An honourable parent company does not want to see its reputation and credibility being destroyed by leaving the creditors of its subsidiaries unsatisfied. Even in the absence of a provision to this effect, the parent company will pay the debts of its insolvent subsidiary.

Group officials usually stress that the issue of the parent's liability does not arise in practice because most groups follow a policy of supporting a subsidiary in financial difficulties and

parent companies often provide assurances to subsidiaries' creditors in the form of comfort letters³⁰. The question that arises here is why, if the overwhelming majority of parent companies support a subsidiary in financial difficulties, should we not introduce a provision for the minority of parent companies which do not honour their moral obligations towards their subsidiaries?

The statements of group officials and the use of comfort letters cannot substitute for legal principle. The legal reality is that, in the absence of a formal guarantee, parent companies are not legally committed to enable a subsidiary to meet its obligations. Cases like the *Multinational case*³¹, the *Cape Industries case*³² and the *Re Augustus Barnet case*³³, manifestly prove that there are parent companies which do not hesitate to shield behind their limited liability for their subsidiaries' obligations when they consider it to be in their own best interests.

Another possible objection may be that the proposed provision ignores the interests of the voluntary creditors of the parent company. It is true that these creditors may have entered into the particular transaction with the parent company in the reasonable belief that the parent's assets will be used to meet solely its own liabilities and may not have taken any protective measures for the case these assets are used otherwise. When, however, the parent is called upon to meet the liabilities of one of its subsidiaries, creditors of the parent may find that some or even all of the parent's assets are used to satisfy the subsidiary's creditors and there are no assets left for their own satisfaction. Especially in the case of the insolvent liquidation of the whole group, the parent's creditors may find themselves competing with the claims of all the subsidiaries' creditors against the parent.

Against this objection it may be argued that, if a provision imposing liability on the parent company is to be statutorily introduced, potential voluntary creditors of the parent will be aware that the parent's assets may be used to satisfy the claims of its subsidiaries' creditors. Accordingly, when negotiating the terms of the credit with the parent, creditors will take care to obtain information about the financial standing of the group as a whole and not only about the parent company and they will take into account the risk of the parent being called to meet its subsidiaries' liabilities.

30. See *supra*, introduction to Part II.

31. See *supra*, ch. VI, B, ii.

32. See *supra*, ch. VI, B, i.

33. See *supra*, ch. VII, B, ii, b, 2.

There is a number of other objections that can be raised against the proposal under consideration, for instance why impose liability on the parent company for the debts of its subsidiary and not merely subordinate its claims against the subsidiary to the claims of the subsidiary's external creditors; or, on the other side, why merely impose secondary liability on the parent company and not joint and several liability on each company of the group for the external debts of each of the other companies of the group. There is also the relevant problem of the identification of the company on which liability should be imposed: should it be only the ultimate parent company of the group or any intermediate holding company? There is also the problem posed by the foreign element whether to extend the responsibility to a foreign parent.

As a practical matter, a solution to all these problems cannot be given by a single provision. The proposed provision does not purport to constitute a panacea for the enormous issue of group trading; it merely seeks to tackle only one aspect of it. For a comprehensive legal regulation on group trading it is necessary to develop a coherent body of rules and principles specifically applicable to groups of companies. This presupposes the development of the concept of the group as a *sui generis* polycorporate association which cannot fit within the existing legal framework for independent companies. If, in addition to the already existing provisions on group accounting, the proposed or a similar group liability provision is introduced, there will be a more solid basis for the development of the group concept and for the review of the existing law, which the Cork Committee considered a matter of urgency more than a decade ago.

APPENDIX

This appendix contains the results of the small survey which was undertaken for the purposes of the thesis. The main objective of the survey was to obtain some basic information on the structure, the organization and the policy of some large groups of companies and especially on the patterns of dependence between parent and subsidiary companies.

Introductory letters and draft questionnaires were sent to 25 domestic and foreign companies which are either parent or subsidiary companies of a group. Almost half of them reacted positively to our enquiry. Group officials of eight U.K. companies readily accepted to arrange a personal interview in their offices. Group officials of three companies, one domestic and two foreign, sent written answers to our draft questionnaire whereas the group official of Ford U.K. Ltd. answered to our questions by the phone.

With the exception of the official of a Japanese parent company, all the officials contacted allowed us to use the names of their companies in relation to the information provided, but, in their majority, they made clear that they would not wish to see their positions or names appear in the thesis. In compliance with this request, the names and the positions held by the officials contacted are not mentioned. It suffices to mention that, in their majority, they were members of the boards of their companies responsible for legal or financial matters.

I. Interview with the official of I.C.I. Plc., the overall parent company of the I.C.I. group.

Qu. 1: What is the legal status of your company?

-We are the overall parent company. We have some hundreds of subsidiaries. For the most part our subsidiaries are 100% owned. There are certain cases where we have got joint venture companies on a 50-50% basis or where we have more participation, e.g. 60%. There are not many companies where we have less than 50%. We do not regard I.C.I. of South Africa, where we have an interest of about 34%, as a subsidiary. In Australia, we own 65%, the balance being in public ownership. It is regarded as a subsidiary but we have really have an arm's

length relationship with it. So, we have a very different attitude to this sort of companies that are 100% subsidiaries.

Qu. 2: What are the reasons for the proliferation of subsidiaries?

-Within the group, the creation of subsidiaries is nearly always for national reasons or taxation reasons. For instance, if you take Europe, in an ideal world you can have one company. But because of national laws and in particular because of taxation laws you end up with a proliferation of subsidiaries. But, they don't add anything. We think of them just as all the group as one.

Quite often when you buy a new business and you buy a company, it tends to stay within the group as that company, again mainly for taxation reasons. When there is a good business reason and no fiscal disadvantage we probably fold it into a national company or bring it totally within the existing operating companies. Definitely, one of the reasons of proliferation is historical.

Qu. 3: Do you have dormant companies?

-Yes, there are various dormant companies. We quite often leave companies as dormant because you never know if you may need them in the future. They might often be a useful vehicle to carry out a particular transaction, they might have a name or a licence that you want to use. Equally, it is often more trouble to wind up companies. It is easy to just leave them there, to fill in once a year the return in respect of them. They have a couple of directors. If you try to liquidate some of these companies, it involves a lot of trouble. But if there is no reason for keeping one company we will liquidate it but only if it is totally dormant and you take out all its assets and liabilities. But quite often we find it easier to leave it there in some jurisdictions. You never know when you might need them in the future.

Qu. 4: Does the legal separation into parent and subsidiary companies conform with the managerial organization of the group?

-For taxation purposes, yes. For managerial purposes, no. You have to be careful that since you have a subsidiary there for a particular reason, e.g. taxation or whatever, it is necessary that it is seen to be making its decisions and to have properly constituted board meetings and that everything is kept in order. But in actual fact, that is almost a legal fiction in terms of how we actually manage our businesses and operate the group.

As I.C.I. currently stands, there are eight international major businesses. They are in practical terms operated in a worldwide scale but in legal terms they are not. In legal terms, we have

more than one company in every country of the world through which the trading will be done. But in management terms, the board of I.C.I. France does not determine the policy of our company in France. It is the headquarters of the business wherever that is located.

Qu. 5: How the group is divided?

-We have product business groupings with the territories being there purely to support the businesses locally. It is very much group divisions.

Qu. 6: Does the subsidiary enjoy managerial autonomy or is it controlled by the parent?

-Legally the subsidiary does enjoy autonomy, but in practical terms it does not. Without the complications of the national laws or the tax laws you would wipe out these complicated groupings of companies. It is the business chain of control that really determines where decisions are made. There will be certain areas where subsidiaries will enjoy some autonomy. Sometimes for example, a legal entity company might relate to a particular business area in which case if it is solely dealing with that business, then it will probably does make decisions validly, but always subject to what somebody else says not in legal terms but in guidance, direction. We tend to use guidance.

Qu. 7: How the parent company intervenes in the management of the subsidiary?

By issuing general policy guidelines?

By determining financial, personnel and marketing policy?

By controlling the day-to-day management of the subsidiary?

-In practical terms, all those things are relevant almost in a business context, not in a legal entity context. A lot of the legal entities just do what is the minimum required of them. It is really the businesses that determine what they want, always observing the legal formalities. So, in a way there is delegation of authority down. There are legal entities, they are there, they operate properly and they buy and sell goods and everything is done absolutely properly. But in management terms because somebody is a director of a company it does not really mean anything.

Qu. 8: What sort of authorities are delegated down?

-In legal terms, obviously the subsidiary can do whatever it wants. But in authority terms, it would very much depend on what the business is. Effectively, we have the board of the parent on the top which it then delegates to the heads of the major businesses the authority to run their own businesses within certain limits: they can spend up to a certain amount of money, they can buy and sell businesses up to a certain amount of money. Above that, they have to refer back to the board. The heads of those businesses delegate certain amount of authority down to other

people but no subsidiary company would do anything unless it knew it was within the policy of that relevant business of the company as a whole.

Qu. 9: If a subsidiary wants to change its accountants or lawyers will it ask permission from the parent company?

-To a logic extent, yes. It certainly cannot change its auditors because we use the same auditors throughout the group. Also, with respect to lawyers, we would want to keep control on which lawyers are used either through the businesses or the centre. Having said that, at a local level, the ICI Spain for instance, can decide if they want to buy new cars or if they want do various things. But I.C.I. Spain cannot decide to build a new factory although legally it could. In group terms it cannot. It could only do that if effectively the head of the business says yes. Effectively that decision is made in the business, not in the subsidiary company. Legally, of course, it will always be the subsidiary company resolving in its minutes, in a board meeting to build a new factory.

Qu. 10: Does it often happen that the same persons sit on the boards of more than one companies of the group?

-There will often be senior people as directors in a particular territory or location. But the more important for a person is what is his title in the whole organization, not he fact that he is a director of companies. In group terms, it does not really mean a great deal who is the finance director in Spain.

The heads of the businesses do not sit on the board of the parent company. We take the view that what the heads do is to run those businesses. It is not their job to get involved in the totality. Their prime responsibility is to achieve the maximum profit in the business. We effectively have a board of executive directors here who do not run the businesses on a day-to-day basis. The heads of the businesses come in and report what they are doing to the executive directors here. It is quite possible that you could have a head of the business not sitting on the board of the company.

We take the board of the parent very seriously. This is very properly done. All the rest are properly documented. But we do not give much importance to the subsidiary boards because the problem is how business is organized today and it is organized transnationally and subsidiaries are mainly national. You observe the legal formalities of the subsidiaries but they are not important beyond being at fiscal advantage. They are not really a core part of our thinking, at least the 100% subsidiaries.

Qu. 11: Are the different companies of the group engaged in diversified activities?

-Yes, we are an enormous group. Different companies will do lots of different things. They will sell lots of different products in all the different businesses. With the exception of very few, all the group companies deal with the main activities of group. There are very few examples where subsidiaries do activities in which the rest of the group is not involved in. Basically, everything is directed towards what the group says, what the group should be doing. Otherwise, it gets just too diversified and people devote too much resource to what it is not in the group's interest even though it might by itself be quite profitable.

Qu. 12: Do the different companies of the group have different names and do they use different trademarks for their products?

-Yes, different companies do have different names quite often. We are going through an enormous problem now deciding how we are going to call our new company. We are splitting the group into halves and we are still working out how we are going to call the other half.

Different companies often employ different trademarks. What might be an acceptable trademark in one country might be an obscene word in another country. Most of the subsidiaries will contain in their names the I.C.I. title in one form or another, but not all. We have got some new companies which we left to trade in their names but we make sure that somewhere they have an identification of the corporate identity.

Qu. 13: Are the companies of the group internally financed?

-If you mean that they raise their own money, no. The finances are all controlled very carefully on a group basis. So, for example, a subsidiary company would not be allowed to go out and borrow money other than with the permission of something above it. It will not be able to charge its assets and what it does with its profits is told by others. It does not decide what it does with its profits.

Qu. 14: Do money come often from the parent company?

-If it is advantageous to do it for financing reasons we might invest money by way of share capital, by way of loan from the parent, or, if local financing rates are favourable, we will borrow locally. There is no general pattern. For the most part we will provide the money, especially for trading subsidiaries. We have financing subsidiaries to raise money. Local companies may have overdraft facilities and they might, in certain cases when it is cheap, borrow money on their local market, but not as a general rule.

Qu. 15: Does the parent company enter into arrangements with the subsidiary's creditors? Are letters of comfort preferred over formal guarantees? In the latter, are subordination clauses used?

-Letters of comfort are preferred. We would never let a subsidiary default. Most people know that when they are dealing with one of our companies they should not be too worried, because they know effectively that we will stand behind it. We would never let a subsidiary company going into liquidation owing money because that would severely undermine our credibility with our other lending institutions. We do issue of letters of comfort. We try to avoid them actually if we can but we prefer them over formal guarantees for balance sheet reasons. But quite often you can get away without providing anything, especially for small overdraft facilities. But if we are raising big amounts on a foreign bond market, then inevitably we give a parent company guarantee. The institutions will insist on that. No subordination clauses are used.

Qu. 16: Has the issue of the parent's responsibility for its subsidiary's debts ever arisen?

-To date no. You could see situations of environmental incidents where the subsidiary is worth £1,000,000 and the liability is going to be £1,000,000,000. That might make people think and yet at the end of the day we think of that subsidiary as I.C.I. so the chances are that we will stand behind it because the damage if we did not would be so enormous in business terms. Our policy is to stand behind the debts but we try to avoid saying so. A sensible bank will ask a parent's guarantee. For our credibility as a worldwide group it would not be too clever if you start letting your subsidiaries default. That would make trading very difficult.

Qu. 17: How you criticize the rule of limited liability?

-I think that limited liability for the subsidiary is on the way out and certainly we do not rely on it. It does not really nowadays conform with what large international groups do. When you trade with Shell, you don't think "Oh, what is this company I am dealing with". You are just dealing with the whole group. That said, if you can foresee of some gas accident happening, then you might certainly think carefully about it. But if you take, for example, Union Carbide, if they tried seriously to say "Oh well, that is Union Carbide India, it goes into liquidation, it has nothing to do with us" they would be crucified. You just can't wash your hands like that.

II. Interview with the official of General Electric Company, the overall parent company of the General Electric group.

Qu. 1: What is the legal status of your company?

-The General Electric Company Plc. is the parent company of the group and is a listed company in the London Stock Exchange. It has a large number of subsidiaries throughout the world. They are mainly wholly-owned subsidiaries but there is a small number of partly-owned subsidiaries particularly outside the U.K. where it is important to have local participation. Within our subsidiaries we have divisions. By divisions we mean an unincorporated business as part of the company.

Qu. 2: What are the reasons for the proliferation of subsidiaries?

-The reasons for forming subsidiaries are mainly the following:

a. You cannot have directors of divisions. You can call them something or another but people who run businesses like to be called directors and there is a sort of a prestige involved in being a director. b. There is a number of tax issues involved both in the U.K. and outside the U.K. You would not want to have a non U.K. division of GEC in a foreign country; so, for tax reasons this will be treated as trading by the foreign company. Generally, in the U.K. you can group your profits for tax purposes within the group so you can have the profits of one subsidiary set off against the losses of another. So, there is no disadvantage in doing that. Although there are disadvantages on the capital gains side: you cannot actually group capital gain so you cannot set off capital loss of one company against the capital profits of another. Those are some general considerations. c. A company such as ours which is grown by acquisition, it acquired companies which they remained subsidiaries. The GEC Plc. was involved in the restructure of the U.K. electronics industry in the 1960s. You acquire companies as you go along. It is very difficult to change structural arrangements. It takes a lot of time and effort, giving rise to very complicated tax issues, so you keep them as they are.

Qu. 3: What kind of divisionalization do you have?

-Let me give you an example. We have a subsidiary called GEC Marconi which is primarily involved in the defense business and Marconi was acquired by English Electric soon before we acquired English Electric. The divisions are really run on a product basis, there is a Marconi Radar business, a Marconi Underwater Systems business. What we do in those circumstances in order to give the management the position of directors of those companies is actually what is known as a management company: even though the Marconi Radar business is a division of GEC Marconi, we will form a management company, the Marconi Radar, which will be an agent of GEC Marconi and has the task of managing the division and the officers will be

appointed of that management company. In that way you can continue with the divisional operation but at the same time you have boards of directors.

Qu. 4: Are the divisions something separate from the subsidiaries?

-We have subsidiaries and we have divisions within subsidiaries. At one time GEC had a number of divisions but they have been sold over the recent years. We had a lighting business which was a division of GEC but we sold it to Osram in Germany a few years ago. We had GEC Telecommunications which was a division of GEC but we merged that business with what was the telecommunications business of Plessey in 1988 and we transferred the division into a new company which went into a joint venture. These things are fairly fluid. You cannot have divisions unless you own 100% of them. As soon as you have other economic interest in the business you have to incorporate the division into a separate legal entity. GEC is virtually and exclusively a holding company now. It does have one division which is GEC Meters but amongst its subsidiaries, there will be divisions within subsidiaries.

Divisions have to be within a single subsidiary. By definition, a division is an unincorporated part of a company and if you are talking about different companies you have to have different divisions. If, in fact, from the business point of view, you want to enlarge the division by adding part of another company, you would transfer the assets to the company which owns the division.

Qu. 5: Does the legal separation into parent and subsidiary companies conform with the managerial organization of the group?

-Yes, it does; we have about 200 businesses within GEC. For example, even if Marconi-Radar is a large company with a number of divisions, we will have a management company responsible for managing that part of Marconi. So, there will be Marconi Radar, Marconi Underwater Systems and a subsidiary company will have its own board of directors, its own managing director, its own finance director. The organization does reflect the management organization. So, the legal structure should, for the most part, follow the management organization. There are exceptions to that in a group of our sort but generally speaking that is true. We also have supervisory function. There will be somebody who has supervisory responsibility for a number of subsidiaries.

Qu. 6: Does the subsidiary enjoy managerial autonomy or is it closely controlled by the parent?

-We have a very devolved style of management. We have 200 businesses throughout the world. We are not clever enough at head offices to run all these businesses. So, in terms of running the business, the management has almost complete autonomy. We, here, obviously exercise

control, we get monthly reports from all our operating units and we look after the financial function, we see whether it is generating cash, we look after legal functions to a degree, but not exclusively. Our role here is essentially supervisory; we are looking after the shareholders' interests in those businesses.

Qu. 7: Do you establish budgets and capital expenditure or the subsidiaries decide on them themselves?

-The company and its subsidiaries have a financial year which ends the 31st of March. In December to March before the beginning of the financial year, we have budget meetings here. Each subsidiary comes here and presents its plans for the forthcoming financial year. Those plans are not approved but if they are not satisfactory, they are thrown out. Within that budget, there will be capital expenditure, projections, etc., and provided that the capital expenditure is within the budget, the subsidiaries do not need to come here for further approval. But capital expenditure above specific amounts require approval from here. So, there is not complete financial autonomy.

Qu. 8: Is it only in financial matters where the parent company has a decisive influence?

-It is also in contractual matters. If a unit wants to enter into a contract involving more than £1,000,000 (the figures vary from unit to unit) or contains unusual conditions, this contract has to be approved here. We are interested from the financial point of view to see what the return is on the contract and also from the contractual conditions point of view.

Qu. 9: How the terms of intervention by the parent company are laid down?

-In two ways. One is a circulus which goes out from the head office to the managing directors of individual units while other rules are laid down in budget meetings, as well. There are written instructions and guidelines, in relation to matters, generally. They may go to managing directors, they may come from me in relation to legal matters or they may come from somebody else in relation to contractual matters, or they may come from the financial director in relation to financial matters.

Qu. 10: If a subsidiary wants to hire more people or it wants to change its auditors or its solicitors, does it have to get approval from the parent company?

-If a subsidiary wants to hire more people, it is up to the individual business, although if it wants to hire somebody at a salary above a certain level, it has to get approval from here. Essentially it means that as far as the people in the factories are concerned it is completely a matter for them to decide. If, however, they want to hire somebody with £40,000 or £50,000 per year, they have to go to the supervisory managing director for approval.

As far as the change of auditors is concerned, that would not be done without the approval of the finance director here. As far as solicitors are concerned, we use several firms of solicitors. There is an instruction that subsidiaries cannot instruct outside solicitors without getting my approval except in relation to routine debt collection. When somebody does not pay a bill they go to a local solicitor, to write a letter, for example. But for anything more complicated than that, they have to get approval from here.

Qu. 11: Do the different companies of the group have different names and do they use different trademarks for their products?

-Yes; obviously GEC appears in the names of most of our subsidiaries. However, there are other businesses in GEC which have their own distinctive marks. Marconi is a very famous name. GEC generally had other names from time to time depending on the specific businesses.

Qu. 12: Are the different companies of the group engaged in diversified activities?

-Essentially, our main activities are in relation to electronics and electrical matters. That is a very wide spectrum of activities. There should be for the most part some basic technological connection between the companies. But we have companies which they have nothing to do with the mainstream businesses. We sell companies every year and we buy others from time to time. Although some people regard us as conglomerate, our activities are not so diverse. They all have an electronic and electrical core.

Qu. 13: Do you have a finance company?

-We do not have a company whose task is to finance the other companies of the group but we have one or two companies who lend money to our customers. Particularly in the U.S. we had a company called GEC Finance partly intended to lend money to customers of the business but that was not very successful. One reason being in the U.K is that we do a lot of our businesses with major customers which do not actually need finance from their suppliers: BT, the Ministry of Defense. In America we have a subsidiary called Pica International which sells sophisticated medical diagnostic equipment to hospital and to doctors and they have a finance company to help buyers purchase their goods.

Qu. 14: How are the subsidiaries of the group financed?

-They will ask us. GEC has virtually no external borrowings. Having said that there may be an overdraft in a company but we are the bankers to the subsidiaries. The subsidiaries cannot go to a third party for a loan of a substantial amount; they will come here. We have lots of cash and we do not want to waste money borrowing it. It is also part of the ethos or philosophy of GEC not to be a major borrower. If you look at our balance sheet you will see there are no

borrowings and quite a lot of cash. So, there is not the possibility that a subsidiary enters into an agreement for a long term facility with an external creditor.

Some of the subsidiaries will have a substantial share capital, other would be financed by loans from the parent company. It is just a matter of bookkeeping, and what is convenient in terms of tax and things of that sort. Loans to subsidiaries other than for trading purposes are essentially equity whatever you describe them. So, we will regard them as equity in any event. There are all sorts of considerations. With foreign companies you have local tax rules about thin equity and things of that sort. It is also easier to get money out of companies if you have loans rather than share capital.

Qu. 15: Has the issue of the parent's responsibility for the debts of its subsidiaries ever arisen?

-I think the answer to that is no. Clearly, as a legal matter, in the absence of guarantees we do not have responsibility for the debts of our subsidiaries. There is no doubt about that. Having said that, it is very difficult for a public company to allow one of its subsidiaries to become insolvent. There are exceptions to that principle. We have a situation in Canada: in 1989 we bought Plessy together with Seman. Plessy had a subsidiary in Canada which they paid \$100,000,000 for the year before we bought Plessy. It transpired that notwithstanding that, it was in a complete mess and in fact was insolvent. We did not think we had any moral responsibility. It was a subsidiary we just acquired. The general principle would be that we would always stand by our subsidiaries in relation to the activities of that subsidiary. But if, for example, we bought a subsidiary either on a private treaty or a public acquisition, and before we became involved in its management of affairs we discovered that its financial position, either because it was misrepresented to us or for some other reason, was insolvent, I think we would take a very robust view on the matter. But generally speaking we would always stand by a subsidiary in the normal course.

Qu. 16: Does the parent company enter into arrangements with the subsidiary's creditors? Are letters of comfort preferred over formal guarantees? In the latter, are subordination clauses often included?

-I do not like letters of comfort. In the normal course it does not make any difference because you stand by your subsidiary, but, on the other hand, the legal consequences of a letter of comfort are uncertain and changing according to the terms whereas guarantees require precise corporate actions with resolutions of the board and authority to enter into them. Letters of comfort are entered into much more easily without going through the formalities. I think it is a matter of general corporate governance. Given our sort of financial situation, I prefer

guarantees because at least you know what your obligation is and there is no misunderstanding. This is my view. I do not know whether my colleagues would agree on that.

Letters of comfort in the U.K. are different from letters of comfort in the Continental Europe where they are regarded as having binding effect. In the U.K. there are cases which make it clear that there is a certain amount of uncertainty. There is obviously a reluctance of some companies to give guarantees because it counts in relation to their borrowing limits and things of that sort, which problems we do not have.

We have agreed on subordination clauses with banks. But subordination agreements have very doubtful effect in the U.K. It is really a question of what extent you can override the Insolvency Act and other legislation. Auditors sometimes say they will not give a going concern certificate in relation to the accounts of a company unless there is some form of subordination letter. That is when the situation arises; usually with a newly formed activity which is not actually making profits and owes money to the bank, perhaps. I have been involved in a couple of reductions of capital and there have been subordination agreements which were very simplistic in their terms. We have unsatisfactory laws on subordination of debts in this country.

What would often happen is that we produce a set of accounts at the end of the year where there would be sums owed to GEC and sums owed to external creditors. The auditors would say "we cannot actually sign the audit report unless you confirm to the company that you are prepared to subordinate the repayment of your debt to the debts of the other creditors". I do not think we would make the arrangement without the creditors. We would insure them that we would write to the company and say we are prepared to do this so that they continue to trade, the directors might get nervous at that stage, etc.

Trade creditors ask for these clauses. We never had a subordination agreement with outside creditors. It would be with the company:

- a. to satisfy the auditors and
- b. to make directors happy that they are not breaking the law.

It would be something of academic importance only, really.

Qu. 17: How do you evaluate the rule of the limited liability of the parent company for the debts of its subsidiary?

-Clearly in the ordinary course is of no consequence whatsoever. It only becomes important if in fact a subsidiary cannot meet its obligations. As I said earlier, the invariable practice

would be to stand by the subsidiary even though the liability is limited. The issue becomes of practical importance if the subsidiary and the parent cannot meet their creditors. If you have limited liability, it protects the liquidator, I suppose, in relation to his obligations. He cannot indulge in those gratuitous gestures because he has different creditors to deal with. In the normal course limited liability is of no great significance, as a practical matter. It might be of importance for a small company, for traders who convert themselves into small companies, although they might be asked to give personal guarantees. It does not make a great deal of difference. It makes people feel more comfortable, however, to have limited liability.

We have no express policy on limited liability. Fortunately, our subsidiaries did not have to face this problem. When you have groups like Maxwell and Pollypeck which go bust and the parent has one set of creditors and the subsidiary has another, then becomes quite important. As far as accidents are concerned we would hope we were insured to deal with them. The insurance we think is important is the disaster insurance.

Qu. 18: Do the different companies of the group have common directors?

-Generally speaking, directors of the parent company would not be directors of the subsidiary companies. There are one or two exceptions but particularly in overseas companies. Very important directors of subsidiaries, such as people who run businesses which have turnovers of more than £1,000,000 per year, would expect to be promoted to the board of the parent company. There is a sort of a social attitude in this country that until you become the director of a parent company you are not really successful. In the normal course, operating subsidiaries will have their own boards but they would not function as boards. They have the necessary meetings to fulfil their statutory obligations but if there is a problem they do not sit round as a board. They just have the central management board try and make decisions.

III. Interview with the official of Unilever Plc., one of the two parent companies of the Unilever group.

Qu. 1: What is the position of your company within the group?

-Unilever has an unusual structure. It has two parent companies. One is a U.K. Plc. and the other is a Dutch N.V. Both are quoted and both have independent shareholders and they are linked by a series of agreements at the top level so that they always have independent shareholders and they always agree to declare the same dividends according to a certain formula. In a sense, they agree to manage the two businesses as if it was one business. Each set of shareholders is completely independent from the other. Our memorandum or articles is

so written that the prime object of the business is to follow through these agreements that link the two companies together.

The two parent companies are solely holding companies without employees. They are just the legal entities which are represented on the Stock Exchange and whose shares are owned by the outside world. And one tier down from them there will also be holding companies at the national levels. It is only until you get down to the third tier when you have the big trading companies. And that basically tends to be the end of it. In management and trading terms it is all very simple. The legal history we have is a bit more complicated than that.

Qu. 2: What are the reasons for the proliferation of subsidiaries?

-The reason for the proliferation of subsidiaries is simply historical. You tend to have a certain type of business in a certain country within a particular subsidiary. That is how it originated. Although for tax and other reasons we would like to integrate them, in many cases we are obliged by historical inheritance to keep the structure as it is. We do review these things from time to time. Basically, it is just a product of our diversity.

Qu. 3: Are all the subsidiaries wholly-owned?

-We have hundreds of subsidiaries almost all of which are wholly-owned. We have a strong preference for having management controlled businesses which means, if we can have 100% ownership we will do so, so there are no destructions or other shareholders with different objectives. We are prepared not to remit money back to the centre if we want to reinvest that for a particular company's development. In many countries, local laws require local participation. In those cases, we have no choice. We have to try and be careful to choose partners who see things the way we do. There are fashions: at the moment we seem to be going to rather more joint ventures than we used to. 15-20 years ago we were getting fed up with joint ventures because it is rather difficult to find the right partner. There are relatively few businesses which are not 100% owned. The one thing we would always want is full management control.

Qu. 4: Does the legal separation into parent and subsidiary companies conform with the managerial organization of the group?

-The legal structure is that we have two separate parent companies. However, the management structure is that we have one entity. You will find that 99% of the people in the company have no appreciation of the legal structure. They are not interested in the legal structure. All management, all internal accounting, all internal financing is largely independent of the legal structure. We think of Unilever as one entity. It is only the lawyers, the tax people, the

company secretaries that have to remember the formal shape. To some extent, the same philosophy applies to the distinction between holding companies and subsidiaries. We let people manage their part of the business and we try and make sure that the legal structure does not get in the way. The legal structures do not always match the business structures. We have a completely parallel set of internal accounting rules which are basically what people have to achieve, what they report to, how their performance is judged. We then have to adapt those for statutory reporting purposes. So, we have both internal auditors and external auditors. We have all those internal accounting procedures as well the external ones. We are not too interested in the external ones, they are constructed according to legal rules which are not always sensible, but they are legal rules. Their only real relevance is for reporting our performance to the shareholders, investors and analysts.

Below the two international holding companies there are subholding companies. There will be one for Dutch business, one for U.K, one for U.S., and below that it tends normally to be a trading company, but sometimes there are further levels, as well. In an ideal world, we would try to ignore all these legal structures, we would like to work on a divisional basis because legal structures, to some extent, get in the way. But they are there mainly for historical reasons. We have grown over fifty-sixty years through amalgamations, disposals, acquisitions and in many cases we are stuck with the existing legal structures because that is where a particular business is and for tax reasons we cannot move it. That is particularly true in the U.K. Overseas, we have actually reorganized all the businesses within a particular country because for tax reasons it was advantageous to do so.

We would like to work on divisions because it makes things much simpler from the legal and accounting point of view. Having said that, the strength of Unilever is in fact in its separate trading companies. It presents itself as Lever Bros., Van den Bergh. Those are the companies that the people know and it is those companies with their brand names that we actually actively promote. Unilever only exists as the ultimate holding company which is known to the investment community and probably nobody else at all. So, in one sense, there is a slight conflict. On the one hand, for managerial and financing reasons, we would like to have just divisions and not legal entities. On the other, for ease of presenting ourselves as Lever Bros. etc, that turns to be more easily done as a separate legal entity. In other countries, they have overcome that; they managed to have just divisions and I suppose we could do the same in this country if the tax regime suited this.

Qu. 5: How you organize your management?

-This is the way we organize our management: we have a main board of directors which is the same for Plc. and N.V. There are three or possibly four different types of directors on that board. There will be a director responsible for each of the main product functions: for detergents, for personal products, for chemicals and there will be a little group of 2-3 responsible for food. There will be a group of directors responsible for a particular service, e.g. personnel, social development, corporate development. There will be a small group of directors who look after the rest of the world because in our main markets which is Europe and N. America, we organize things on product lines. For the rest of the world where our business tends to be much smaller, e.g. Nigeria, we look after food and detergent and personal products. So, for the rest of the world since we tend to be multi-product company we have regional directors. So, there will be a director who looks after all our businesses in Africa and Middle East covering a wide range of functions.

The fourth class of our main board directors is what we call a Special Committee which is in fact our chief executive. We have a rather unusual creature which is what we call the plural chief executive. Basically, we have a small team, a small Committee, consisting of the Dutch chairman, the English chairman and one other, sometimes an Englishman, sometimes a Dutchman. Those three form a special Committee which in a sense are the chief executive. They in fact look to the long term, they take the big decisions. In a sense, they are a class above the ordinary board members. So, that is where all the management focuses in at the board level. So, you will have the detergents organization throughout Europe. All focuses into the detergents director. He will have a staff of managers looking after commercial aspects or personnel aspects or technical aspects throughout Europe.

Below that level we have the company chairmen. The company chairmen are given their general policies, they are given their financial targets, they are basically given their money to earn a certain return on. They have a fair discretion as to how they do that. In the past, they had a very wide discretion. More and more, as our businesses are more clearly transnational, more and more we are setting guidelines on personnel matters, marketing policies, trademark policies. It used to be, only 10-15 years ago, that Europe was literally a whole series of national markets and because national tastes were clearly very different, we did not have that many supranational brands. Different companies in those countries had a fair amount of discretion. As Europe is becoming more clearly one market and as we have concentrated on trying to make particular brands supranational, then our policies have also become rather wider, less nationalistic. Strangely enough, there is a trend towards more policy setting from the

centre than it used to be. But within the terms of the general policy, the company chairmen will tend to have a quite wide discretion.

We tend to have a very intensive education program. People who are seen as potentially the chairmen of the future are given a sort of express training. They are spotted and given extra training and clearly they get used to working in the Unilever manner. There is a certain style. They get trained according to our accounting policies, they become familiar with that, they will be moved around, not only from company to company but possibly going abroad, as well. So, they will have seen a lot of Unilever. So, it is a matter of education. They have a high awareness of what is expected of them. This is why, to some extent, there are relatively few written guidelines, because the whole culture is self-perpetuating. There are few general guidelines but the group is managed as one unit at the highest level. In practice, it tends to be managed in management units divisions. We do have national management, as well, but in Europe it is relatively weak. It is basically there to ensure that the national employment laws are complied with and taken into account. So, we have a parallel structure on a national basis but it is relatively modest. It is there only for advisory service.

Qu. 6: How does the parent company intervene in the management of the subsidiary?

By issuing general policy guidelines?

By determining the financial, personnel and marketing policy?

By controlling the day-to-day management of the subsidiary?

-Basically, what happens is that each year the management of a company will formulate detailed plans of what it is going to be doing in the next year, over the next five years and gets those agreed with the senior managers that it reports to, who are basically the team that works with the relevant director. So, it is not really intervention through general guidelines. It is more a matter of agreeing operating policy through negotiation on an annual basis according to long term plans. It tends not to be a matter of dictating from the centre. It is really a matter of negotiating. Clearly, the people from the centre have an overall view. At the moment, we are very keen to make sure that companies are aware of the need to generate cash because for the last few years borrowing money was restricted. In other times, the policy might be to make sure that people realize that they must be earning good profits. In other times, there may be a fashion for cutting down on hidden expenses, unnecessary costs. So, there are often fashions of thinking which will get fed into the annual plan negotiations. They tend not to be guidelines as such. There are very few guidelines. There will be guidelines on good corporate behaviour, on consulting the centre before agreeing a local tax bill, but they are few. We have policies on no sex or race discrimination, on being a good corporate citizen. It is very easy to write

down a general statement. How it is really implemented in practice, it is a matter of discussion between the relevant trading company's management and the people who set their targets.

Qu. 7: Are the different companies of the group engaged in diversified activities?

You will see from our review that we are fairly diversified. Our core businesses are fairly clear and probably detergents is the one which is more widely represented around the world followed by personal products and food.

Qu. 8: Do the different companies of the group have different names and do they use different trademarks for their products?

-We are a multinational conglomerate. We have accumulated different company names, different brand names. Some of them have changed over the years, some have gone, some new ones have come. We are trying to develop "suprobrands". We tend to find that it is a little bit difficult for various reasons. We do not have brands quite like Coca-Cola or IBM or whatever. We are trying to make our existing brands a little bit more multinational. Some brands like Lipton tea are pretty well known. Others which are very well known in the U.K. are completely unknown in Europe and vice versa and we are very slowly trying to remove those. There are some very clear advantages of having single brands. You are then more easily able to adapt an advertising idea or a marketing idea from one country to another.

Qu. 9: Are the companies of the group internally financed?

-Financing tends to be done centrally. We have a central treasury department which on behalf of Unilever as a whole borrows money. In overseas countries there may well be banking and exchange control problems and there they will have then to borrow locally. We tend to expect companies to be pretty well self financing. So, either there will be money lent from the centre, if that is possible, or, there will be guidance from the centre as to how to borrow efficiently. We are extremely creditworthy so we find it very easy to borrow money. We did not make a dramatically large acquisition for 3-4 years now, so we actually have accumulated a fair amount of cash. Our borrowings are relatively low. We borrowed quite a lot of money some years ago to make some big acquisitions and we are fairly rapidly paying those off.

We would prefer to finance from the centre because the centre can borrow most efficiently. We would prefer to borrow by whatever is the most tax effective means. I do not suppose we want particularly lots of money tied up in equity, we prefer to lend it because that is more flexible. But all is done entirely on a pragmatic basis of what is most effective and what the local law requires. Since we can borrow extremely efficiently from the centre, that is the way we prefer to do things: to have centrally organized finance.

Qu. 10: Does the parent company enter into arrangements with the subsidiary's creditors? Are letters of comfort preferred over formal guarantees?

-We tend for historical reasons and presentation reasons to expect our subsidiaries to present themselves as companies standing on their own feet. We do not expect them to be leaning too much on us for assistance. They are supposed to go and arrange supplies with their creditors and arrange leases of property. We are very disinclined to give parent company guarantees. Fortunately most of our subsidiaries are quite substantially on their own right so that by and large they do not need guarantees. We do not want to have big figures in the accounts for contingent liabilities and guarantees. We fortunately have such a good reputation that, to a very large extent, outsiders are very happy to do business with us without any form of comfort.

There tend to be two examples where we tend to have to give a parent company guarantee:

- a. Where we are borrowing very large sums of money. For various tax reasons is a good idea to borrow money via a particular subsidiary. Sometimes subsidiaries are set up especially for that task. We have a particular company set up in the U.S. for borrowing money. Since that company has no other function than to borrow money, it has no real assets and it obviously needs a parent company guarantee before people will lend it money.
- b. At the other extreme, there is a strong tradition in the U.K. that landlords of property like to have a parent company guarantee for a tenant's lease. Quite often we manage to avoid this, but just occasionally for some of our smaller companies, we might have to give a parent company guarantee.

Just occasionally, there will be a need for comfort letters which we in fact review from time to time. In some ways, we do not like comfort letters because they are morally binding. As recent case law indicates, they can be legally binding, as well. They are certainly ambiguous. So, the preferred legal view is not to give letters of comfort. If we want to give a legal commitment we give a clearly enforceable guarantee. If we do not want, we do nothing. But the legal perfection is not always observed by our commercial and banking colleagues. So, there are occasions where letters of comfort are given. We try to make sure that they definitely do not have any legal effect.

Qu. 11: Has the issue of the parent's responsibility for the debts of its subsidiaries ever arisen?

-The reality is that we have never ever let any subsidiary anywhere go into liquidation without all of its credits being met. Since we can actually prove that we have a perfect record in this matter, we are frequently not pressed for formal guarantees of even for a formal letter of comfort. To the best of my knowledge, we have always met the responsibilities of our subsidiaries. Over the years, the issue has occasionally arisen. You may have a company in

a country where the economy is so bad that the only possibility is to liquidate it. In some countries, they have such strict capital adequacy regulations that if a company is doing bad there is no choice but either to pump in much more money or to liquidate it. Just occasionally, the only sensible commercial decision is to liquidate it. The creditors are always satisfied. We would always have to make sure that enough money is in the subsidiaries that all the creditors are satisfied. In fortune, we are so big that we always manage to keep that policy observed. We also tend to take a long term view. Even if we leave a particular country, we expect that we will go back there some years later. We are very keen that our reputation is always a good one. For that reason, we find it worthwhile to satisfy creditors in some situations where we do not have to.

Qu. 12: What is your opinion on the rule of limited liability as it applies in groups of companies?

-From our point of view, it is a nuisance. It has no relevance to business practice at all. We would not hide behind limited liability. The fact that there are limited liability companies helps some people by giving them the ability of saying that they are directors of a company. It does help in providing a framework for a particular business unit. But by and large it is a nuisance because we have to keep separate accounts, those accounts have to be separately audited, we have to have all the regulatory framework there, company secretaries, directors keeping records of their shareholding in Unilever, lots of filing and shareholders' meetings and directors' meetings. Although we try to simplify all that as much as possible, we still have that apparatus which is a nuisance. It serves no commercial function at all. The management operates completely independently from the legal structures; sometimes they coincide but it is only a coincidence. Meetings of directors of the operating companies are merely commercial meetings taking place in order to be recorded for the statutory books. They will meet formally as a board only when absolutely necessary: to formally approve the annual report and occasionally to approve the sealing of a document. But these are pure formalities. The legal structure serves very little commercial function. We would be quite happy to work with divisions so as to have one legal entity for the U.K. Maybe because we are conglomerate, it might be that we would have one legal entity for food, one for detergents. We would probably do that because employees can only think with relatively limited horizons. Most of our employees in the factory they do not think themselves of being members of Unilever, they are identified with Lever Bros. So, it might be that we would have one detergent business for the whole of the U.K. That is probably the way we would go.

We have never let a subsidiary going into liquidation without ensuring that all the creditors are paid off because we take the long term view. We have seen that having an extremely good

name is good for a business. It means that our accounts are not full of guarantees and we do not have the inconvenience of lots of comfort letters with people looking at them wondering whether they are effective or not. It makes life much simpler. It surprises me how informal our suppliers, customers, bankers are when they are dealing with us. Considering how much business we do and how widely, it is surprisingly how trustworthy we are. A local bank manager will lend one of our companies or open it an overdraft and a few weeks later he will send them the paper saying "by the way, you better sign the documents for the head office". It is a fairly relaxed environment which is not typical of most of the people you will see. If the tax laws will permit, we would happily get rid of most of our legal structures. We would operate in big divisions because legal structures just get on the way.

Looking at it academically, if we were asked whether we are in favour of the abolition of limited liability, we would say yes. When you go, however, to the practical details of changing people's employment contracts, approaching landlords, at that point we would say it is not worth the trouble. If we were starting with clean sheet of paper we would say we have no difficulty. But since we have this historical position, it would be quite awkward to go from here to there.

IV. Interview with the official of Philips U.K. Ltd., a subsidiary of Philips of Holland.

Qu. 1: What is the legal status of your company?

-The Philips group has several companies in the U.K. At the top there is the Philips U.K. Ltd. Under it there is the Philips Electronics U.K. Ltd. The first is a holding company. Most of the assets in the U.K. are in the second. Primarily the business is divisionalised so we try to keep the number of subsidiaries to a minimum and at the moment we try to get rid of some of them because it saves administration costs the less companies you have. But we still have some subsidiary companies. Among others, there is Philips Lighting U.K. Ltd., Philips Finance Services Ltd. and Philips Medical U.K. Ltd., although we are making the latter a division. The overall parent company is in Holland. Philips U.K. Ltd. is owned by the Dutch company by 100%. All the others are 100% owned by the Philips U.K. Ltd. Only one happens to be 75% owned.

Most of the business is in the Philips Electronics U.K. Ltd: the consumer division which has got a turnover of £1,000,000, the telecommunication division, the components division. These divisions are not separate legal entities; they are all parts of Philips Electronics U.K. Ltd. For historical reasons there are separate subsidiaries most of which we are going to get rid of

transforming them into divisions. We would not do it to a small subsidiary because there is a trading reason: it handles our exports and there is also a tax reason for keeping it. The same applies to the Philips Finance Services Ltd. Mainly all the companies support the main activity of the group which is consolidated in the Philips Electronics U.K. Ltd.

Qu. 2: Does the legal separation into parent and subsidiary companies conform with the managerial organization of the group? -It does not. This is the problem in the Philips world that Philips worldwide is structured in product divisions mainly based in Holland, so you have a consumer product division which sells televisions and audio equipment, a medical product division which sells medical equipment, a components product division which sells components and a lighting product division which sells lighting products. All of the divisions are multinational in their own right because they are very large. The components division worldwide has a turnover of 20 billion guilders. So, the managing director of the consumer division, for example, in the U.K., reports directly to the board of the consumer division product group in Holland even though he does not run a separate company. So, there is no legal structure. Fiscally, of course, the situation is very different. This applies to all the product divisions. So, the legal structure does not follow the actual managerial structure. A product division can consist of a lot of subsidiaries throughout the world, although they would not necessarily be separate companies. The point is that legally the consumer division is part of the U.K. company. It is not a separate company. Managerially it is managed from the product division in Holland. Only in the case of Philips Lighting U.K. Ltd. and Philips Medical U.K. Ltd. there is a coincidence between legal division and managerial division.

Qu. 3: Does the subsidiary company enjoy managerial autonomy or is it closely controlled by the parent?

-The subsidiaries are managed on a worldwide basis; they are managed from the product divisions. They are managed on a global basis. Commercially the control is exercised by the product divisions. No question about that at all. The head of the consumer division reports directly to the respective head in Holland. The head of the board of directors in the U.K. has certain overall responsibilities: for the promotion of the Philips name and the extension of the general market, political responsibility for making sure that the political channels are well investigated. Legal responsibility for the structure of the group is local. We are responsible for the structure in the U.K. and we have some fiscal responsibility and some personnel responsibility for general recruitment; but most of that is done in the divisions. The head of the U.K. group reports to the board in Eindhoven for the whole of the U.K., but not for the profit of the U.K.; he reports just for the things he is responsible for such as promotion of the Philips name.

Qu. 4: What kind of directives do the subsidiaries receive from Holland?

-Within certain product guidelines, the subsidiaries will be responsible for the day-to-day management. It is difficult to explain precisely. The pattern varies according to the division concerned. In some divisions they are beginning to sell on a European basis, so the managing director of the lighting division in the U.K. might also have responsibility for selling to certain market areas in Europe. None of the heads of the commercial divisions have responsibility for the factories which are run separately. They are just told which product is available and they sell it.

Qu. 5: Who is in charge of the financial policy? Who determines the budget and the investment policy?

-The national organization here has more to say on that, for instance when there is a capital budget for a project. The product division has also to say something on that.

Qu. 6: Who takes the decisions concerning personnel and marketing? -Personnel are handled here except for the senior people in which again the product division is responsible. In general, the subsidiaries are operated as if they were divisions. The managerial structure is precisely the same.

If we want to change our legal or tax consultant, Holland has almost nothing to say. But auditors are the same worldwide so we may have some difficulty in changing them.

Qu. 7: Are the companies of the group internally financed?

-The finance is generally done from here, the centre. We have a finance department in case one company requires funds or any other financial arrangement. We arrange the finance for the subsidiaries and the divisions. The parent gives loans. We provide legal services, fiscal services to the divisions. Divisions have not their own legal departments, but they have their own personnel. If they need money they come to our fiscal department. Generally, we raise money in the U.K. market.

Qu. 8: Does the parent company enter into arrangements with the subsidiary's creditors? Are letters of comfort preferred over formal guarantees?

-We have often been asked for guarantees or letters of comfort for some of our subsidiaries. We have always in the past refused to take the step to provide guarantees or letters of comfort to Dutch companies. For various reasons we only gave guarantees within the U.K. Our policy is to keep guarantees within the U.K. Only occasionally we guarantee for foreign companies. It is not particularly banks which ask for guarantees; this happens only occasionally. If you are

doing large contracts, particularly with a local authority, the local authority will want guarantee from the parent. If it is a large project they prefer guarantee than letter of comfort. Normally, no subordination clause is inserted. We only provide a guarantee up to the value of the contract.

Qu. 9: Has the issue of the parent's responsibility for the debts of its subsidiaries ever arisen?

-No; it is our policy to support a subsidiary in difficulty but this is not specified in any group document. I cannot imagine any circumstances where we would not support the subsidiary but we do not want to commit ourselves to this effect. As a matter of policy Philips will stand behind its subsidiaries and in any event they may have some sort of difficulty because of the way they are structured.

It is a question of risk; if we go into a particular area of business which is very risky and we put money into it, under English law one can walk away. Theoretically and practically, I suppose, people might be reluctant to put in their money unless that prevails. People might be much more cautious about entering into business ventures.

Qu. 10: Do the same persons sit on the boards of more than one companies of the Philips group?

-Our board of directors is not composed of persons holding a seat in the board of the parent company in Holland. There is no cross-directorship at all between us and Holland. Our subsidiaries do not have many board meetings. Although they have their own boards, they are run by management committees rather than boards of directors. In general, our directors do not participate in the management committees of our subsidiaries.

V. Interview with the official of Shell U.K. Ltd, a subsidiary owned 60% by the Dutch Royal Dutch Petroleum Co. and 40% by the English Shell Transport and Trading Co.

Qu. 1: What is the legal status of your company?

-We have two parent companies: Royal Dutch in Holland and Shell Transport and Trading which is an English company. From there we have a series of operating companies around the world and our system is very much to make the world operating companies, from which Shell U.K. is one, to be autonomous companies and their shareholding goes back to Shell Transport and Trading and Royal Dutch. It is a very complex structure. We do see in that structure Shell U.K. as being a totally autonomous operating company. Across the Thames river is the international company Shell Transport and Trading which has shareholdings all over the world.

The Shell U.K. has operating subsidiaries and has an independent board here in the U.K. Almost all the subsidiaries are wholly owned. There is a couple where we have outside shareholders. Our shareholding goes up to Shell Petroleum Gulf Ltd across the river. The Dutch companies go up to the Dutch Shell Petroleum company, the U.S. companies go up to the U.S. holding company. Ultimately, all these three companies are brought together in the two parent companies.

Qu. 2: What are the reasons for the proliferation of subsidiaries?

-In some ways, the reason is historical since we bought by acquisition different businesses which were already incorporated and we left the structure as it were. Within the division of Shell U.K. oil there are direct subsidiaries of Shell U.K. which are small little businesses within the division. Shell Chemicals is an incorporated company and beneath that there are a number of another subsidiaries.

Qu. 3: What determines whether you are going to incorporate a division or not?

-It used to be tax considerations but it is no longer the case. First of all, if you have a partner you have to create a discrete corporate entity. It may be because of the nature of the business. We are a high cost industry. We do not want to have Shell terms and conditions before we incorporate a separate company which has its own terms and conditions for employment. Essentially what we prefer to do is to operate as Shell U.K. and clean up the structure and get rid of those subsidiary companies as best as we can. Some operations with marketing tasks will remain but generally within Shell U.K. we do not like subsidiaries at all.

Qu. 4: Does the legal separation into parent and subsidiary companies conform with the managerial organization of the group?

-Sometimes it goes right against the managerial organization of the group. The object for us is to have a single company and unless there are overriding reasons for having a subsidiary we would prefer everything to be divisionalized.

Qu. 5: Does the subsidiary enjoy managerial autonomy or is it closely controlled by the parent?

-In the case of Shell U.K., it has autonomy as all the 100 companies. They all have autonomy from the parent company. In effect, there is autonomy, there is a separate board with three outside directors, it makes independent decisions but within the overall Shell conditions that we all subscribe to. These conditions relate to things like health and safety. Always these guidelines are adapted into each jurisdiction. For Shell U.K. they will be adapted to English law. Basically, our personnel structures, our levels, will be the same around the world. But

again, we make allowance for local situations. There are essentially guidelines but management usually adapts to local conditions.

Qu. 6: How does the parent company intervene in the management of the subsidiary?

By issuing general policy guidelines?

By determining the financial, personnel and marketing policy?

By controlling the day-to-day management of the subsidiary?

-The parent company does issue general guidelines and it has service companies which advise us with competent financial people who would liaise on behalf of the shareholder with the operating companies, with us here. We are talking about planning scenaria, where our strategic efforts should be made, should investment go in the U.K., should money be spent in the Mediterranean, should be spent somewhere else. These advising companies on behalf of the shareholders would liaise with these people and they will build up a business plan. But we cannot say that they manage the subsidiaries. Absolutely not; they just advise us. In general, there is no disagreement between the board of the parent and the board of the subsidiary. They manage to reach a consensus. The service companies are separately incorporated and they are the servant of the same company. They have the same relationship to the holding company as we have. They are all 100% owned.

General guidelines are issued on health and safety policy, on engineering, on consistent Shell standards for retail sites, again in consistence with the local laws. There is consistency in financial reporting for group requirements but there is autonomy, there is no control in day-to-day management by the holding company. And equally we act in relation to our subsidiaries, to a degree, in the way that our parent company acts towards us, although we, perhaps, have a little bit more hands on. We are more immediately responsible for our subsidiaries and you will find a director of this company or one of his nominees sitting on the boards of these various subsidiaries. So, there is more immediacy in the U.K. in directing these companies. But for us, vis-a-vis our ultimate shareholder, there is no day-to-day management or control.

Qu. 7: Are the different companies of the group engaged in diversified activities?

-We have got three essential divisions: chemicals which is incorporated, explo standing for exploration of production which is a division quite different although they are interlinked by sending gas, and the downstream group.

We do not have a company with the task to finance other companies. We have a treasury group but not a separate finance company.

Qu. 8: Do the different companies of the group have different names and do they use different trademarks for their products?

-They all use the Shell trademark which is very heavily guarded and is licensed to us from the Shell International. That is one of our great assets. That and Coca-Cola are the two greatest brand names and trademarks of the world. There may be different brand names but you will always find the Shell indication somewhere. Some of the small subsidiaries do not have the Shell emblem but they are on the verge of disappearing. In all others you will find the Shell trademark consistently used.

Qu. 9: Are the companies of the group internally financed?

-Essentially yes. Shell is pretty bigger than many banks in the world. This company in the U.K. essentially finances internally its own subsidiaries and is itself financed by the group holding company. Usually, this finance takes the form of intercompany loans; only sometimes takes the form of subscription to capital increases. I know that in other countries, not in the U.K., it takes the form of increased capitalization. There is no reason why it could not take this form, but for the moment it basically takes the form of loan capital. The rates of interest and dividends are pretty well arm's length. There is often a lot of debate about what the shareholder expects. It is always a commercial rate and we are expected to produce a commercial rate of return. We might get a mildly favourable treatment but it will be on the basis of the fact that we are a good risk. We save on margins. But in every sense there is no concession. We could say, as this company, Shell U.K., says, "we are going out to do an external borrowing", but if our shareholder across the river says "look, we can make funds available to you and we are prepared to do so on a commercial rate" we will say "great, fine".

There can be internal trading with other operating companies in Europe; we will sell them chemicals and we will buy things from them. Because of taxation reasons we have to make sure that there is no transfer pricing involved in these transactions.

Qu. 10: Does the parent company enter into arrangements with the subsidiary's creditors? Are letters of comfort preferred over formal guarantees?

-We do not like formal guarantees. Certainly, at the level from the holding company down to us, they do not like guarantees, probably they will not give guarantees. Down to the next levels, occasionally we give performance guarantees when dealing with local authorities. But by and large we do not guarantee subsidiaries and letters of comfort make us feel pretty uncomfortable. So, the preferred course is that only in unusual circumstances we might give either a guarantee or a letter of comfort. It is the exception rather than the rule. There is a number of reasons for not giving guarantees and letters of comfort.

Qu. 11: Has the issue of the parent's responsibility for the debts of its subsidiaries ever arisen?
 -Not at the upper level but yes to the lower level. It has arisen only because someone found it convenient to exploit. We had a joint venture with Barclays, Philips and Shell and one of the people who provided services to that company believed that the issue would be supported by the three shareholders, Barclays, Philips and Shell. We did not agree. He tried to say that this was not an independent company, it was a Shell company and Shell should be liable to pay him. It has been subject to litigation, it has been resolved but he did not win.

Qu. 12: What if the company was a wholly-owned subsidiary?

-If we felt culpable our position would be different in those circumstances. This was not a wholly-owned subsidiary; we had only 33,33% and the reason that he lost had nothing to do with us.

Let me give you another example. We do have a company that has been the subject of litigation. Again this company went out and sold wall insulation and we were not happy with the glue and we sued the supplier of the glue. We believed that there will be claims by customers against us in respect of that company. It was a 100% owned Shell company, the insulation was marketed with the Shell brand on it. We have kept that company which without our support would be insolvent. We have kept that company and until all claims are satisfied we will keep and support that company. It is a classic example that we are prepared to stand by the Shell name.

In the previous case the creditor was engaged in advertising campaigns. He was foolish. His problem was that he had a bank overdraft, he was driving his Ferrari and, when we sold the company, he should have an ongoing relationship and for reasons which had nothing to do with us that relationship broke down; it was his fault. It was a case we believed we had no responsibility to support the company.

The one case is an example that we do stand by the company. In the other case where the claim was made allegedly because of Shell ownership we will say no. People try to exploit. They try to take advantage of Shell name. If the claim is an honest, moral claim there is no question that the claim will be met. We have our reputation to maintain.

In the first case, it was recognized that there was no claim against Shell, so the litigation has stopped.

The cases were not reported. The second has been discontinued; it did not go far at all. It is only in the public domain in the sense that proceedings were filed but it has been discontinued. It was an insurance claim. We were claiming against the manufacturers of the glue which broke down and caused the insulation to be destroyed. We sued Unilever and we settled on an undisclosed basis which was very satisfactory to us, but there is no decision in this case.

Qu. 13: What is your opinion on the rule of limited liability as it applies in groups of companies?

-In some countries, for example Australia, where you agree with the regulatory authorities to be released from filing separate accounts for each of the subsidiaries, you undertake to support the subsidiaries. By virtue of what is called a class order you are released from heavy financial reporting obligations. As long as the class order remains in force you effectively guarantee. The guarantee is enforceable by prosecution by the government authorities, the regulatory agents.

I think that the limited liability rule is important for groups of companies. I may be old fashioned. It is fine if you make the election in the Australian way. But I think because somebody elects to have discrete operations in a group with subsidiary companies that should be respected. Limited liability is a very important tool and it should not be eroded.

People through their own naivety, often stupidity, they choose not to make enquiry. I do not see creditors being ripped off and cheated by doing business with companies. We are pretty sensitive about paying on time. There is a standing instruction 'do not extend credit'. We do not want to delay payments.

Qu. 14: Are there cross-directorships in the Shell group?

Two directors of the ultimate parent company and of another company sit on our board here. There are extensive cross-directorships. In some of the boards of our subsidiaries sit directors of the main U.K. Shell board. In many ways they are nominal directors since some of the companies are dormant.

VI: Interview with the official of BMW (GB) Ltd., a subsidiary of the BMW AG of Germany.

Qu. 1: What is the position of your company in the BMW group?

-We are talking about BMW GB Ltd. which is a private limited company. Ultimately, it is the subsidiary of BMW AG in Munich. We have half a dozen of subsidiaries but the most interesting ones are three dealerships which is something we acquired recently; they are located in London. There is also a finance company which we set up as a joint venture but we bought the outside interest this year. So, there are four key subsidiaries: three dealerships and the finance company. The whole group is controlled from Germany, from BMW AG. BMW AG has subsidiaries in all the European countries, together with U.S., Australia, New Zealand, Far East and a manufacturing operation in South Africa. All of the subsidiaries are wholly-owned; this is the policy of the group.

Qu. 2: What are the reasons for the proliferation of subsidiaries?

-There are two reasons: as far as the finance company is concerned, we always wanted our finance company and we got the know-how from the joint venture. Once we felt confident enough, we bought them out. Secondly, with the dealerships, they were strategically placed and they were having some financial problems. We did not want to loose them; so we ended buying them rather than supporting them. We acquired the third dealership in London because it is very important to be in that part of London. Through the dealerships we sell the cars because we don't sell the cars from here; we only sell through dealers. Most of the dealerships are independent limited companies. The overall parent company is an AG.

Qu. 3: Does the legal separation into parent and subsidiary companies conform with the managerial organization of the group? Do the subsidiaries in general enjoy managerial autonomy?

-Effectively, yes. The parent company is managed separately from the subsidiary company. We have a large amount of autonomy. Clearly, the parent company approves budgets, approves major capital expenditure, it would approve the formation or purchase of a subsidiary company and would obtain information about all the key things that they want to know about. Within that, they manage themselves, we manage ourselves. We follow the same principle in regard to our subsidiary companies. You cannot set up a subsidiary with its management structure and then try to control it from here. The subsidiaries have a great deal of autonomy, especially regarding day-to-day running.

We would not change auditors without approval but we could change our local solicitors. We tell them what we are doing and why we are doing it and we make sure that they are

comfortable with it, but there is no reason why they are not, as long as we have sound reasons for doing that. We can hire people up to the limits set to us by the parent company. We apply similar rules to our subsidiaries. We can ourselves arrange our credit and overdraft and we expect our subsidiaries to do the same thing, the exception being the finance company where we actually provide a lot of funds. We try to make use of the group funds where we can.

Qu. 4: How does the parent company intervene in the management of the subsidiary? Does it determine financial, personnel and marketing policy?

-There are general guidelines. If we want to buy property or to lease property or to buy a subsidiary, we have to obtain approval from Munich. Those guidelines form the general policy of the group. I am not sure about determining financial policy. We have a mandate to try to produce the profit we budgeted for and we are expected to take actions to achieve that. In terms of personnel policy, there is very loose uniform policy. As far as marketing is concerned, the last 18 months Munich has tried to have a central marketing policy. Only recently they realized that it simply does not work quite well because the sort of marketing that appeals to the British may not appeal to the French and so on. You may use the same concepts, but it is very difficult to follow a uniform European marketing policy all over the places. There is no day-to-day management by the parent both regarding our parent and regarding our subsidiaries. Since they have appointed the managers, we have to show that we have confidence in them by letting them get on with things really.

Qu. 5: Are the different companies of the group engaged in diversified activities?

-The AG makes motor cars, we distribute them in the U.K; they are sold through independent dealers or through subsidiary dealers. The financing dealers for the purchase of motorcars support the main activity of the group. Although the finance company is a subsidiary of ours, it reports to a different department in Germany. You have one department saying to the finance company "you must make as much money as possible" and another saying to us "you must make as much money as possible". This may occasionally conflict but we manage to deal with them quite constructively. The finance company would not finance a non BMW product.

There are different departments but not clearcut divisions within this company. There is the motorcycle department, the car sales department, the marketing department, the accounts department. We actually consolidate everything here.

Qu. 6: Do the different companies of the group have different names and do they use different trademarks for their products?

-There are no different trademarks, but slightly different names.

Qu. 7: Are the companies of the group internally financed?

-We try that each company stands on its own feet. We try to keep intercompany debts to a minimum. So, we do not keep them going by intercompany loans.

Qu. 8: Does the parent company enter into arrangements with the subsidiary's creditors? Are letters of comfort preferred over formal guarantees? In the latter, are subordination clauses used?

-Letters of comfort are absolutely preferred over formal guarantees. Our parent company has never provided us with a guarantee of any form. They prefer to provide us with letters of comfort which may be different but they seem to work. We follow the same policy with our subsidiaries. We prefer to provide letters of comfort. This is because companies have autonomy and they are funded themselves. We want our subsidiaries to be commercially successful on their own right. It is not the fear that the guarantee is more easily enforceable than a letter of comfort, because at the end of the day we will not let a subsidiary go bust because of the damage of reputation that it might do to the group. There might be some internal reasons again between us and the finance company when we might want to decide where the losses should lie for tax reasons. It may be sensible to have some losses in the finance company, for instance, so it saves us more than get a guarantee. You actually carry the losses because it makes sense from a tax point of view to carry them. You also may say to them "we want you to be profitable so we will take the losses". So, to some extent, you have a little bit more flexibility if you do not have formal guarantees. No subordination clauses are used.

Qu. 9: Has the issue of the parent's responsibility for the debts of its subsidiaries ever arisen?

-No; when this building was built, when the company was first set up, I suspect that the parent company entered into the contract for it to be built and then it came to the ownership of BMW GB, but that was only because our company was not operating at that time. Apart from that, there has never been a need for the parent company to assume responsibility for its subsidiaries' debts. The subsidiaries will always have the funds to pay those debts. As far as possible we make them stand on their own and deal with their debts.

Qu. 10: In case that one subsidiary is a situation near to insolvency is it the policy of the group to support this subsidiary?

-I think what would happen is that either by means of a loan or by capital restructure, we will support the subsidiary; but by not issuing guarantees. We want to remain flexible how we do it rather than have a guarantee which might tie our hands. Never in the history of the company creditors remained unsatisfied.

Qu. 11: Does it often happen that the same persons sit on the boards of more than one companies of the group?

-There is a certain degree of cross-directorships. The managing director of BMW GB is also the chairman of the finance company. The three retail subsidiaries have two directors in common. The finance director is different. We can use that as an opportunity to give somebody experience in being a finance director. It helps the development, so we use different people there. The directors of the retail subsidiaries are entirely different from the directors of this company. But the heads of departments in BMW GB are appointed to be directors of the retail subsidiaries.

Directors of the parent company very usually come and visit the subsidiary company. We see the chairman every couple of years. We see our regional manager who is a director of this company but he works in Germany, probably every four to six weeks; we also see other senior people occasionally.

Qu. 12: Do you consider that the limited liability of the parent for the debts of its subsidiary conform with the reality of the groups?

-Our company is an English company, subject to English law where limited liability is the rule. It seems to me that the alternative is that BMW AG continues to be a limited liability company but no limitations are introduced elsewhere. That is a possible way to operate because we could operate as a branch of our parent company. But the philosophy is to establish companies locally in accordance with local laws, with local connections and so on. It is better because each company can have autonomy and stand on its own feet and you can see how each company in each country is doing and you can take steps if you are not happy with the results. This is also possible with a branch but you might lose track of it. On the whole, being a limited liability company, gives as an understood protection in law. The law relating to limitation of liability is very clear. We know where we stand and we have the autonomy we need to operate profitably.

VII. Interview with the official of Canon U.K. Ltd., a subsidiary of Canon of Tokyo.

Qu. 1: What is the legal status of your company?

-We are a subsidiary eventually of Canon in Tokyo, but we also are a parent company. We have some subsidiaries. Most of them are in U.K. We are wholly-owned. With one minor exception, all our subsidiaries are 100% owned but we have some other companies where we have minority shareholding. When I say subsidiary I always mean 100% per cent.

Qu. 2: What are the reasons for the proliferation of subsidiaries?

-Most of the subsidiaries are operating subsidiaries. They exist because we believe in "small is beautiful", the concept of having a small operating unit with the means to measure the complete activity. As a principle, we are attracted towards forming operations into separate companies. Most of our subsidiaries are like that. Most of our subsidiaries are bits of our organization made into a separate company so that we can more easily measure the performance and reward the management. Other subsidiaries are simply accidents of history. When we want to get involved in a particular business, we do that by buying a company. That's a different reason. So, it is very difficult to generalize. There are different reasons for different subsidiaries.

Qu. 3: Does the legal separation into parent and subsidiary companies conform with the managerial organization of the group? -Usually is the answer. Again, it is very difficult to give absolute yes or no answers, but usually most of our subsidiaries are formed into separate operating units because we want the management to be clearly measured. Therefore, by definition the managerial structure complies with the legal structure.

Qu. 4: Do you follow a divisional structure?

-In Canon U.K. we have a sort of matrix organization. We measure results by product on the one hand and by sales channel on the other. We do not use the term division, but it is the same thing. It is very much two ways; so, product that way and sales channel that way. For example, we sell copiers through National Accounts, through dealers or we sell them direct and we also sell facsimile machines through all those different channels. So, there are no classical divisions, but basically products on the one hand and sales channel on the other.

Qu. 5: Do managers of the subsidiary in general have to report to the headquarters in Japan?

-No, we do or there is the managing director of Canon U.K. who has to report to Canon in Tokyo. The marketing managers of the different products have to account to the product people in Tokyo. They do not report, they report into the UK. They have to achieve targets set for them. Because it is a matrix organization, each product in Tokyo has expectations for what will happen in the U.K. So, the head of copier division in Tokyo will expect the U.K. to sell x number of copiers. It will put a lot of pressure onto the marketing manager in the U.K. to sell that number of copiers. But there is not a straight reporting line. That person in the U.K. reports to the managing director in the U.K., not to Tokyo. But he has a very strong functional responsibility.

Qu. 6: Does the subsidiary enjoy managerial autonomy or is it closely controlled by the parent?

-Generally speaking, the subsidiary has managerial autonomy but there are some individual examples where the parent company puts a lot of influence or pressure on. For example, the parent company expects us to sell x percentage of the production. We, as a nation, are x % of the world economy. Therefore, we should sell the same percentage of the production. And if we do not, we are expected to account for ourselves. So, a lot of pressure is put on us to sell what is perceived to be our share. But there is no direct instruction such as "You must sell 4,250 of this month"; nothing as specific as that. It is more like a managerial target that is set. But on a day-to-day basis there is very little interference or control. We are fairly autonomous. I have in the past worked for an American company where the rules are much stricter. You cannot do anything without asking permission. It is very different working for Cannon: local management is given a lot more authority.

Qu. 7: How does the parent company intervene in the management of the subsidiary?

By issuing general policy guidelines?

By determining the subsidiary's financial, personnel and marketing policy?

By controlling the day-to-day management of the subsidiary?

-We do not receive policy plans or policy manuals. When we are small we are not financially self sufficient. Then we are fairly well controlled. But it is the same as a bank controls a small company. Once we are financially self sufficient, which we are now, then there are very little guidelines. There are a few things we cannot do without getting approval: there is a limit to the amount of capital expenditure, we cannot spend more than ... without getting approval. But the managing director has the approval to hire and fire anybody at any level. So, there not any general guidelines apart from these general expectations that we sell a certain percentage of the production. That is the only general guideline I am aware of. There is no day-to-day management of the company.

The parent company has nothing to do with personnel policy or financial policy. We follow our own financial policy apart from the fixed dividend. Again, there are no guidelines, but we are expected to receive a very general policy statement which comes out from our parent company. It says "you should increase your sales by x per cent and your net profit should be at least x per cent". But it is very general and usually not complied with. So, the control is very loose. It is very much more guidance than "you must do this, you must do that". The general philosophy is very loose control but very strong influence on our sales because we are part of a manufacturing group and we come under a lot of pressure to sell our share. As long as we sell it, there is no problem. But if we start not to sell our share, then lots of questions start to be asked.

Qu. 8: If you want to change your auditors would you consult the parent company?

-Yes, but not because that is an instruction, but because we are part of a group and is important that all the auditors use the same standards to measure. Even if we are very unhappy with our auditors, that probably would be quite difficult to do. The parent company would not say "no, you cannot do it"; they would just ask very searching questions as to really why we want to do it because that might cause problems with the audit of the group. But there is nothing to prevent us, for example, from stopping use the auditors for tax advice or our solicitors. Because the auditors have to do a report that goes to our parent company, it is important for them that the same standards are used. The preference is we all use the same company. But, for example, in our group in the UK, not all the companies use the same firm of auditors. Our parent company does not say to us "you must have the same auditor for all your companies". It just says "when you are submitting your own accounts, we would prefer if you use the same auditor". So, it is fairly strong, but not absolutely mandatory.

Qu. 9: Are the different companies of the group engaged in diversified activities?

-No. Most of the subsidiaries are following the main activities of the company but there are some exceptions. A company of the group sells loudspeakers; no any other company does that. Also, a wholly-owned subsidiary of Canon U.K. repairs personal computers and personal computer systems which we do not do in the rest of the group.

Qu. 10: Do the different companies of the group have different names and do they use different trademarks for their products?. Generally speaking, no. Generally, all the companies are called Canon apart from one exception. They also use the same trademark.

Qu. 11: Are the companies of the group internally financed?

The companies of the Canon U.K. group are internally financed. We have trade credit from our parent company when we buy goods but it is fairly normal, nothing special. We pay 30 days which is very small credit for international trading companies. We charge our subsidiary companies very strict terms. So, generally speaking, there is not much internal credit. Where one of our operating companies has not been very successful or it is new and needs borrowing, then we arrange it. So, we will lend them money; but that is not usual. Only if it is necessary we will do it.

Qu. 12: If you need funds will you raise them from your parent company?

-No, we will raise it ourselves. We have a fairly long standing company with a fairly strong balance sheet. We do not need to go to our parent company. We used to do that in the early

days when we did not have a strong balance sheet, but now we do not need to. So, if we need to raise funds now, we do it ourselves. If we need to, we borrow from all the major banks.

Qu. 13: Does the parent company enter into arrangements with the subsidiary's creditors? Are letters of comfort preferred over formal guarantees? In the latter, are subordination clauses used?

-When we first started and we were financially not very strong, we needed very clear guarantees from our parent company. As we progressed, creditors and banks needed a softer and softer guarantee. So, we went from guarantee to letter of comfort but now we do not need anything. So, we have borrowing facilities now; we do not have guarantees in place, at all. The same applies to our subsidiaries. Sometimes, when they are very small, they will need guarantees from us. Gradually, as they get bigger and healthier, they need letter of comfort and then nothing. I do not remember including subordination clauses in a guarantee to one of our subsidiaries.

Qu. 14: Has the issue of the parent's responsibility for its subsidiary's debts ever arisen?

-Only once: 10-12 years ago, we bought one of our dealers which was in financial trouble and we did not realize what a bad state it was in. We bought it only because it had lots of Canon customers and we wanted to protect them. Once we bought it, we realized that the company was in a much worse state and we had to put it into liquidation but we paid off all the creditors. So, even if we did not have a legal liability, we did, because we wanted to maintain the good name of Canon. Only small, straight creditors were involved; there were no big creditors. It was quite a small company in Belfast, a copier dealer. The debts included things like rent, Inland Revenue payment, VAT, light bill. There were not big amounts involved.

Qu. 15: Is it the general policy of the group that whenever a company is in financial difficulties, it will be supported by the other group companies?

-I do not think we would like to be committed; it will depend on the circumstances. Generally speaking, if the company is called Canon we would be commercially silly not to support it. But if we have an interest in a company which we kept very clear from us and we say "this has nothing to do with us, we are just the shareholders" it may be that we would not support it unless if we thought the name Canon was at risk. But it has never happened yet. We do not have a clear policy but generally speaking we would support it.

Qu. 16: Do the same persons sit on the boards of more than one companies belonging to the group?

-Yes; our managing director is a director of Canon in Japan. We also have two directors of Canon U.K who are directors of our immediate parent company in Holland. In the U.K., there is a great deal of cross-directorships. I am a director of about four or five subsidiary companies; our managing director is probably the director in six or seven. We only have four executive directors in the U.K. and we are scattered about the subsidiaries. We are not all on every company.

VIII. Interview with the official of Mitsubishi Electric U.K. Ltd., a subsidiary of the Mitsubishi Electric Corpn. of Japan.

Qu. 1: Is your company a wholly-owned subsidiary?

-In the ownership chain of our group, everything is 100% owned with the exception of joint ventures. Internationally, the subsidiaries of the group must be hundreds. Most of the major territories have their own limited liability company.

Qu. 2: What are the reasons for the proliferation of subsidiaries?

-Primarily management, although some would think that the tax is the lead item. It seems that management's responsibility is perhaps more defined by having one company producing one set of results. There is a tendency on each national project to create a subsidiary. So, it does seem that management almost leads tax and legal structures. By management I mean management identification of the business and control.

Limited liability must play some part in the creation of new subsidiaries but I do not think it is the primary part. Obviously, if you are acquiring a new business and you are not entirely sure of the inherent risks and of the environmental problems of buying a factory or something like that, it is seen as beneficial to have a defined downside risk of the share capital investment in that company. Just as a general policy, each new element is put into a new limited company.

Qu. 3: When you acquire a new business do you leave it as it is or you assimilate it in the group structure?

-I know one example in the U.K. which is the acquisition of the Apricot computer business. That was structured as an asset purchase which was transformed into a new Mitsubishi Electric company which was in our ownership and it still remains an independent limited company, a direct subsidiary of Mitsubishi Electric U.K. The reason for that is that it needs to be identified separately for commercial purposes. It is very important to have Apricot computers as a trade name and generating goodwill as a result of that. Also, at management level, the links to Japan

are to the computer works whereas the links of Mitsubishi Electric U.K. will be to the television works, to the video recorder works, the air conditioning factory. All these separate areas have their own connection to the trading subsidiaries internationally so there is no person in Japan who has overall control of operations in Europe as such.

Qu. 4: What kind of divisionalization do you follow in your group?

-Product divisions and geographical divisions, as well, but on the basis that each subsidiary deals primarily in its own territory. So, we have various product groups here: televisions, airconditioning, electronic products, industrial products. With those we deal primarily in the U.K. and in some cases in Ireland. The product groups will report back to the Japanese factories and will place orders on Japan. They have very close links with the relevant Japanese factory but there is not as yet a co-ordinated European product management team, as such. We have liaison staff who link together the different European operations but as yet we do not have a co-ordinated European strategy. I think we will develop it as time goes on, as the European business becomes more significant for the Japanese parent.

Qu. 5: What is more important for management purposes, the subsidiary or the division?

-The reality is that each division is broken down into very small entities. Divisions such as industrial products covers everything from factory products to certain protection products, a very broad spectrum. Similarly, the electronics division covers printers, monitors, mobile and fax equipment: very discrete markets are all under one division for management purposes.

In management terms, the division is more important than the subsidiary. The subsidiary is a consolidation of all these different markets. They are such different markets that the overall result sometimes becomes a little bit meaningless. They are so many different elements. You may have one good year in one consumer product area and a poor year in another. It is much more important to identify success by division.

Qu. 6: Does the parent company interfere with the management of its subsidiary? Which form the intervention takes? Where are the most important decisions for your company taken, in the U.K. or in Japan?

-Here in the U.K., but at the most senior management level which is staffed by Japanese, anyway. There are only very few European directors. In our board, there is one director who is charged with the electronics and the semi-conductor division, another one who is in charge of the Irish branch office, one who is managing director of Apricot computers but there are seven Japanese plus the chairman. The Japanese do not sit on the Japanese board because they

would not be as senior. In a huge organization of 80,000 employees, they may be at the top here but there are low in Japanese terms.

Japan effectively decides on matters such as proposals to create a new factory and major changes in strategy; these would need their thought and approval and would be reviewed by them.

I would inform Japan before changing our solicitors but it would not be their final decision, because the legal department stands at one side, it is not involved in management decisions. I have not a line reporting with my colleagues in Tokyo. There is no obligation to meet to tell them on the legal affairs. As far as change of auditors is concerned, I would be very surprised if somebody acted independently on that because it is part of the co-ordinated international approach of getting the benefits of economies of scale by using one firm of auditors.

If our company wants to hire more employees, it does not have to ask permission from the parent company. It would be a local management decision. Obviously, there will be some consultation about budgeting but just at a strategic point. The actual executive day-to-day business is controlled by the local directors. So, an increase in staff will be for the local directors to decide upon.

In general, it is more a matter of liaison than interference. The parent company has a liaison office in London and it has a number of managers whose task is to collect information from Europe and to return that to Japan. They will have meetings and different management groups to obtain the information that they want. Obviously most of our senior managers are Japanese. They will conduct their business with Tokyo in the Japanese language. So, I and other European managers will have no idea what the subjects of their conversation are. That makes it a little bit difficult to assess how closely the parent monitors day-to-day matters. But they certainly get a monthly report or a report on any major proposal for expansion or whatever.

Qu. 7: In general, would you say that your group is closely managed by the parent company or that the subsidiaries enjoy a substantial degree of autonomy?

-The difficulty is knowing how far the Japanese contact goes, to what level of detail, because even if a lot of detail is sent to Japan, it does not necessarily mean that the Japanese closely scrutinize every information, that they are great collectors of information, they ask far more information than an English company would ever do. They just want to have absolutely everything available to them and they slowly pick their way through the information in order

to decide. But as a matter of practicality, they are not here, they cannot immediately see what the market situation is. So, there has to be delegation to the local managers.

Qu. 8: Are the different companies of the group engaged in diversified activities?

-Normally, we simply follow the group activities. It is unusual to commence a new business as Mitsubishi Electric U.K. Sometimes, in the engineering sector they have new product development or sometimes our staff here will think of some specialist application and pursue that themselves, but that is very unusual. It is a more vertically integrated group.

We have nothing to do with Mitsubishi Motors. There is no legal relationship, there may be fractional amounts of shareholding although we will supply components. It is only one tenth of 1% of our share capital that is owned by other Mitsubishi companies. We are part of the same family of companies, it is a bit like an informal club, it is a co-ordination and friendly support for one another. If we are dealing with another Mitsubishi company, we would have a much closer relation with them than with other customers. We would hope that a Mitsubishi corporation would buy Mitsubishi Electric products for their own use. We would not be as aggressive with other Mitsubishi companies as we would be with third parties. Occasionally, there is a direct conflict because products like air conditioning are produced both by Mitsubishi Electric and by other Mitsubishi companies.

Qu. 9: Do the different companies of the group have different names and do they use different trademarks for their products?

-These things are very closely monitored indeed. We have very strict rules about how we can use the 3 diamonds logo. There is a quite thick corporate logo book with rules and regulations on the use of the company name and logo, colour, size, etc.; everything is coordinated internationally. There is very close control of the trademark. There is a separate intellectual property department in Tokyo which controls it internationally. So, trademark issues are dealt with by Japan. Indeed, we cannot form a Mitsubishi Electric subsidiary using the Mitsubishi name without the approval of whoever has control of trademarks in Japan ultimately.

Qu. 10: Does your company ask for finance from external sources or from the parent company?

-There are loans both from the parent company and from third parties bank loans. National Westminster Bank is our primary banker, but there is no charge on the assets to secure those loans. We never charge our assets to the bank. The bank tends to rely on letters of comfort or in some property transactions the parent company issues a guarantee.

We have a finance company in the U.K. which is used for raising capital in the London market by the use of europaper. It provides finance to the U.K. and to other subsidiaries in the group. It provides loan facilities but it does not provide facilities to customers to buy our products.

In case of internal financing by the parent company, the parent company has no charges over the assets of the subsidiary. The cheapest form of financing is the best. There is an external bank loan and an internally raised finance, a loan from, e.g. the finance company to us. The rate of interest is libor plus a fraction; it is an arm's length rate of interest. It obviously costs them money to raise that capital.

Qu. 11: What is the extent of internal trading within the group?

-The extent of internal trading within the group is presumably noticeable. Over 80% of Mitsubishi Electric corp. business is Japan business. Our turnover in Europe is under 10% of our worldwide turnover but there are prospects for expansion. I assume the transactions are arm's length.

Qu. 12: Does the parent company enter into arrangements with the subsidiary's creditors? Are letters of comfort preferred over formal guarantees? Are retention of title clauses insisted upon by trade creditors?

-Letters of comfort are often used and not necessarily formal guarantees. But because we are such a huge group internationally, the parent company turns over £13-14 billions, huge amounts of money. It is bigger than some third world countries. Their relationships internationally are in a different scale. We are very much the juniors, they are the very top level and they have ability to act on trust and understanding.

I am not aware of any instance where a letter of comfort had to be enforced against the parent company

We, in our terms of sale always have retention of title clauses. On purchases, that depends on whose terms actually apply. Our purchase terms do not permit retention of title but obviously the suppliers' terms will have retention of title. As far as I know we did not have a retention of title clause enforced against us but we regularly enforce it against defaulting debtors.

Qu. 13: Has it ever occurred that a company of your group was unsupported by the parent company?

-Not in the U.K. You will see from our results that we are very much dependent on continuing finance from Japan. Because there is a mixture of capital, external bank finance and internal loan capital, it would be unusual to see a company standing alone.

Qu. 14: In the case that a subsidiary becomes insolvent what would be the group policy?

-Difficult to speculate; it would depend on the context and the effect on other areas of the business because if a company is allowed to go into insolvency and there are debts which are not satisfied then our reputation would suffer. We have had companies voluntarily going into liquidation when, for example in U.K., we had two businesses, two limited liability companies, which had become dormant and there was no useful purpose in continuing to write even short form accounts for them. So, we had those companies liquidated but all sums were settled, every creditor was satisfied before the liquidation. If there was a financial disaster, \$100 billions claim against one subsidiary, it would be for Japan ultimately to decide what to do. If something like that happens, the directors would have to ask the parent company whether they have continuing support even on a daily basis. If not, they have to take the company into insolvency.

In general, the parent company always stands behind the subsidiary. The bank will deal with the subsidiary but it always have an understanding with the parent company that they are permitted to make loans, they will check for sure with the parent company before they release capital. For example, if we have a big property transaction, e.g. we lease properties, the parent company acts as a guarantor for the period of the lease once its companies are in occupation. It is a very different style; one I have not been familiar with previously.

I have worked in British public limited companies; there, the situation is very different. There is not as much trust between parent and subsidiary. There is always some fear that the parent company might drop an English subsidiary. But for Japanese companies, the whole style of trading is very different. For example, the companies in England such as Mitsubishi Electric or so, have no charges against them. I have never worked in a company without even a bank charge on it before. All is arranged through parental guarantees, parental understandings with the company's bankers and financiers.

Qu. 15: Do you mean that English subsidiaries act more independently?

-Not necessarily independently. Even if they are under very close control by their parent company, the English directors in an English company are normally very concerned that the parent company might just dump them, leave them exposed to liabilities. English directors are normally very keen to see directors' and officers' liability insurance and I think that now most

of the listed companies will make a reference in their accounts of having directors' and officers' liability insurance to protect them as individuals. Here, however, this is not an area that directors are greatly concerned about. They are mainly concerned if there is any criminal liability against them personally, about matters which can affect the company and themselves as directors.

Qu. 16: Has the new provision on wrongful trading any effect on the directors' behaviour?

-Not in a Japanese group because in Japanese companies the thoughts of their management team is based on trust. We would not consider questioning our parent company whether we have continuing support because we know that we do. Every company in our group has a Japanese director who only spends a little amount of time with the European subsidiary. He then goes back to Japan to his job in the parent company and the Japanese principle is that there is no question that they will not support the subsidiaries. For statutory accounts purposes only, the auditors of, mainly, the weak subsidiaries ask for letters of comfort or any sort of positive statement of financial support.

Qu. 17: What is your opinion on the rule of limited liability, as it applies in groups of companies?

-It is helpful. It does, at least, segment some of the risks, but because of all the understandings, the guarantees, perhaps there are not many areas where the parent company would not be affected by a problem in the subsidiary.

However, you have to remember to whom letters of comfort and guarantees are given to. They are given primarily to bankers which have their own long term relationship with Mitsubishi to consider. There will be other straightforward commercial business creditors, whose situation is very much different. I cannot imagine the parent company needing to issue a guarantee on their behalf in an ordinary commercial transaction, even if it is for the supply of a Mitsubishi of Tokyo product, because we often handle products and take a margin for handling the sales in the U.K. or elsewhere. It would not be necessarily ordinary for the parent company to get involved there. Obviously, the credit risk is for us to pursue. Trade creditors are not normally in a position to insist on letters of comfort. On the contrary, banks are.

Qu. 18: How often do the subsidiary's directors meet?

-Our company does not place great emphasis on board meetings as such. There are only two official meetings of all the directors every year. We used to have more but with such a diverse product area we found that it was not helpful to us, because, at the time available, that board of directors could not address a strategy which covers such wide areas. So, it is more a method

of communicating on a regular basis, every six months, where every one meets and can exchange information but that is not the best way of development of strategy. This needs local meetings of particular market sectors.

IX. Over the phone conversation with the official of Ford Motor Co. Ltd., a subsidiary of the American Ford Motor Co.

Qu. 1: What is the position of your company in the group?

-We are a wholly owned subsidiary of the U.S. parent.

Qu. 2: What are the reasons for the proliferation of subsidiaries?

-Diversification of business, tax considerations, borrowing reasons.

Qu. 3: Does the legal separation into parent and subsidiary companies conform with the managerial organization of the group?

-It depends on the company.

Qu. 4: Do the subsidiary companies enjoy managerial autonomy?

-Not always; sometimes they constitute a mere tool of operation for the parent company.

Qu. 5: How the parent company intervenes in the management of its subsidiaries?

-Policy letter and policy plans are issued. Quite a lot of general guidelines are issued. Even when the subsidiaries' financial, personnel and marketing policy are not determined by the parent, they are extremely similar. Significantly, there is a co-ordination company, called Ford Europe without its own staff and employees. Actually, it is a service company with employees from other national Ford companies with the purpose to co-ordinate and recommend their long-term policy.

Qu. 6: Are the different companies of the group engaged in diversified activities?

-Mainly all the companies are engaged in the sales and manufacturing of motor vehicles. Even the credit and marketing companies have been created for the purpose of supporting the main activity.

Qu. 7: Do the different companies of the group have different names and do they use different trademarks?

-They have the same names and trademarks.

Qu. 8: Are the companies of the group internally financed?

-Nearly all are internally financed, so there are no outside creditors.

Qu. 9: Has the issue of the responsibility of the parent for the debts of its subsidiaries ever arisen?

-No.

X. Written answers received from the official of ITT Industries Ltd, an English subsidiary of the American ITT Corpn.

Qu. 1: Are all the subsidiaries of your group wholly-owned?

-Most of our subsidiaries are wholly-owned. Subsidiaries proliferate because of separate trading activities. Our group is wholly-owned by a U.S. parent.

Qu. 2: In general, does the legal separation into parent and subsidiary companies conform with the managerial organization of the group?

-Yes.

Qu. 3: Do the subsidiaries in general enjoy managerial autonomy?

-Subsidiary management is substantially autonomous in the areas of finance, production, marketing, R & D, capital expenditure and operating budgets. There are global constraints within each area to reduce downside risk.

Qu. 4: How does the parent company intervene in the management of the subsidiaries?

-The parent board of directors rarely takes decisions concerning the subsidiary companies, except for corporate strategy or group tax planning reasons. The parent intervenes in the management of the subsidiary usually only on a general basis. This can cover general guidelines and policies, but not trade related policies or management.

Qu. 5: Are the companies of the group internally financed?

-Yes, the companies of the group are usually internally financed. Internal trading is very minimal, but internal borrowing is prevalent. Substantially, all financing is effected through the medium of an interest bearing loan between group companies. The parent does not usually seek security for the loan.

Qu. 6: Does the parent company enter into arrangements with the subsidiaries' creditors, such as guarantees, letters of comfort and retention of title clauses?

-It is unusual for the parent company to be approached for a letter of comfort or formal guarantee other than for any formal bank borrowings. My parent company is very reticent about giving letters of comfort or formal guarantees. Subsidiaries' creditors more often use retention of title clauses to protect their interests.

Qu. 7: Has the issue of the responsibility of the parent for the debts of its subsidiary ever arisen?

-We have never had to cover the debts of a subsidiary due to its failure. All subsidiaries' debts have always been met for whatever reason the subsidiary may have been closed down.

XI. Written answers received from the official of the Japanese parent company of a group in the automobiles industry.

Qu. 1: Which is the structure of your group as a whole? Are most of the subsidiaries wholly-owned? What are the reasons for the proliferation of subsidiaries?

-The Japanese parent owns several wholly-owned subsidiaries world-wide. The majority of overseas subsidiaries are wholly-owned subsidiaries; we also own subsidiaries which are established as joint ventures with our business partners. The reasons for the proliferation of subsidiaries are myriad: to allow local management to react quickly to changes in local markets, to take advantage of national trade laws that make operating subsidiaries in local markets advantageous, to reduce trade friction and to spread risk throughout the global marketplace.

Qu. 2: Does the legal separation between parent and subsidiary companies conform with the managerial organization of the group?

-The top managers of the wholly-owned subsidiaries usually are rotated from the parent corporation in Japan; however, many of the mid-level managers of the subsidiaries are hired locally and they generally do not rotate to the parent corporation.

Qu. 3: In which matters do subsidiaries enjoy managerial autonomy and in which matters are they closely controlled by the parent company?

-Subsidiaries generally have autonomy with respect to day-to-day decisions regarding sales and marketing strategy, while our subsidiaries follow the overall business strategy and budgetary instructions set by the parent corporation.

Qu. 4: How often and on what matters are the subsidiary's general meeting and its board of directors convened?

-Shareholders' meetings of our subsidiaries are held at least once a year, and occasionally more frequently depending on the necessity. Generally, the board of directors of the parent corporation will meet more frequently, but the number of meetings of the board of directors varies from one subsidiary to another, depending upon business needs and local legal requirements.

Qu. 5: How the parent company finances the subsidiary's operations? By providing a loan, by investing in its debt instruments or by investing in its equity?

-The parent corporation usually finances the subsidiary through an equity investment. The other financing methods include short-term commercial paper or long-term bank loans.

Qu. 6: How an external creditor of the subsidiary, such as a bank or a trade creditor, secures his claim? Does he ask for a letter of comfort by the parent company or for a formal guarantee?

-Owing to the group's credit rating, providing a letter of comfort is usually sufficient for our creditors, though some of our subsidiaries' creditors require formal guarantees from the parent.

Qu. 7: Has the issue of the parent's responsibility for the debts of its subsidiaries ever arisen? Has the group ever been obliged to close down a subsidiary? What happened with its creditors? Our group has not yet had to deal with the issue of responsibility of the parent corporation for the debts of its subsidiary in connection with the shut-down of a subsidiary.

XII. Written answers received from the official of General Motors Corpn., the American overall parent company of the General Motors group (the numbers refer to the same questions as above).

1. Most are wholly-owned. Reasons for proliferation are primarily to isolate local legal presence in foreign countries, tax reasons and joint venture structures.

2. It varies greatly, but managerial organization is not generally a driving factor.

3. Variations are too great to enumerate.

4. Most actions by written consent except for several major subsidiaries.

5. All of the above, depending on circumstances.
6. Generally, we insist external creditors take subsidiary as it is without guarantee or comfort letter. Exceptions in form and substance arise on a case-by-case basis.
7. Yes; circumstances vary, generally creditors not injured.

XIII: Written answers received from the official of Ciba-Geigy SA, the Swiss overall parent company of the Ciba-Geigy group. (the numbers refer to the same questions as in XI)

1. See our Annual Report [there, it appears that the overwhelming majority of subsidiaries are wholly-owned]. In most countries, subsidiaries are a must in view of legal and tax considerations.
2. Yes, in most cases.
3. Autonomy in operational aspects; control in financial matters. As a matter of law, subsidiaries are treated as separate legal entities.
4. As often as local law requires. All local legal requirements are observed.
5. Loan to the extent possible, equity if and when required. Usually, immoveables are equity backed.
6. Comfort letters or guarantee or none of all. No general policy or statement can be made given the variety of the situations.
7. We never have been forced to close down a subsidiary. Where changes due to reorganizations took place, the creditors have been satisfied by the subsidiary itself or by the purchaser who has taken over the business.

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